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TAX EROSION AND THE "BOOTSTRAP SALE" OF A BUSINESS—II *

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Part I of this Article contained an analysis of the doctrines of the "bootstrap" sale as they relate to the increasing erosion of our democratic system of progressive taxation. Part II will be devoted to a detailed consideration of the most recent and most complicated form of bootstrap transfer, the "loss bootstrap," and to general conclusions regarding the process of tax erosion exemplified by bootstrap sales.

IX. THE LOSS BOOTSTRAP TRANSFERS

The Nature of the Loss Bootstrap

Analyzed in Part I were the three "charitable bootstraps": the "original" bootstraps which include the only litigated cases; the "lease" bootstraps which use a leasing technique to avoid certain statutory limitations; and the "cemetery" bootstraps which utilize a nonprofit cemetery as their source of tax exemption. It was inevitable that the bootstrap technique be turned to similar employment in another area of tax-free funds—net operating loss carryovers.³¹⁸

The basic pattern of the loss bootstrap, particularly in its bootstrap transfer of ownership, follows the format previously described. A

* Part I of this Article appeared in the March issue. Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business—I*, 108 U. PA. L. REV. 623 (1960) [hereinafter cited as Part I].

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³¹⁸ See, e.g., Winton, *Loss Corporations and Carry-Overs*, 34 TAXES 549, 554-55 (1956).

group of promoters acquires effective control³¹⁹ of an affiliated group of corporations with large loss carryovers (Loss Group). After liquidating its prior business activities, Loss Group sets up a new, wholly owned and thinly capitalized subsidiary (New Company). New Company then purchases a profitable business (Profit Company); even though New Company has only a few thousand dollars in assets, it negotiates the purchase of Profit Company for millions of dollars—an inflated price reflecting the fact that New Company has no substantial assets or other bargaining advantage except Loss Group's loss carryovers. The small down payment is taken out of the old profit business, either directly, or indirectly by a pledge of its assets. The agreement usually provides that seventy-five to eighty per cent of the pretax profits of the business be paid to the former owners (Owners) of Profit Company until the agreed price is paid. In the meantime, Owners receive management contracts and retain other significant powers of control,³²⁰ such as the ability to recapture the business in the event of default.³²¹

Finally Profit Company is affiliated in the filing of a consolidated return with the members of Loss Group, and the latter's net operating loss carryovers are thereby offset against the income of the former. This technique is dependent upon a combination of loopholes, one judicially created and legislatively perpetuated³²² and the other administratively fashioned,³²³ in order to utilize a source of tax-exempt funds, namely, the loss carryovers. Affiliation in a consolidated return, as a tax planning technique, thus parallels the charitable "feeder," the business "lease," and the "nonprofit" cemetery.

³¹⁹ Acquiring 50% or more of the stock of the loss corporation might subject the transaction to the limitations and disallowances of §§ 269 and 382(a) of the INT. REV. CODE OF 1954. However, effective control may, except in unusual circumstances, be secured without acquiring a full 50% of the stock.

³²⁰ Other powers of control are noted in the text accompanying note 324 *infra*.

³²¹ The ability to recapture the business in case of default is a more significant sign of retained control than is the case in the ordinary installment sale. This is due to the far greater risk of recapture which results from the facts that the new corporation is thinly capitalized, that, as in *Emanuel N. Kolkey*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958), the down payment is often taken directly from necessary working capital, and frequently that a *de facto* inflated price is charged.

³²² If a loss company acquires a profit company, rather than the latter purchasing the former, judicial decisions to be considered at notes 373-81 *infra* and accompanying text interpret § 129, Int. Rev. Code of 1939, added by ch. 63, § 128(a), 58 Stat. 47 (1944) (now INT. REV. CODE OF 1954, § 269) so as to permit the "peddling" of loss carryovers. The 1954 revision of the Code perpetuates this problem.

³²³ Where a single loss company acquires a profit company, the former may not, in a consolidated return, offset losses before affiliation against profits after affiliation. *Treas. Reg. § 1.1502-31(b)(3)* (1955). On the other hand, an administrative interpretation of the regulations allows such an offset if the loss company previously had one or more affiliated subsidiaries with whom it filed a consolidated return. See text accompanying notes 441-50 *infra*.

Owners may retain even greater control over the acquired business in a loss bootstrap situation than with the charitable bootstraps. They may be represented on the board of directors of New Company by as much as fifty per cent of its membership;³²⁴ they may acquire a minority stock interest in Loss Companies as well as in New Company; and they may retain a proxy to vote the stock of New Company or Loss Companies, or both. In addition, they retain the entrepreneurial risks. Inasmuch as Loss Group does not commit itself to pay the price³²⁵ and New Company is virtually penniless, there is no independent purchaser with substantial assets to give reality to the commitment to pay the "sales" price. And even if New Company had had substantial assets, it would not have committed them as the agreements expressly provide that the bulk of the payments are to be a percentage of the income of the transferred business.³²⁶ In some loss bootstraps, the "sales" price itself is not predetermined but rather varies with the income of the profit business.

The inflated price³²⁷ in the loss bootstraps presents the same evidentiary problems of valuation and "arm's length bargaining" as does the charitable bootstrap. If hindsight is relevant to valuation,³²⁸ proof that the price paid was inflated is difficult inasmuch as the continuing economic boom has often resulted in the Profit Company having far greater financial success than normal standards of valuation would have indicated at the time of the transaction.

It is difficult to see that Owners have undergone the substantial change in their position which is characteristic of a "sale." If the

³²⁴ See BOTANY MILLS' ANN. REP. 11 (1957).

³²⁵ BOTANY MILLS' ANN. REP. for 1957 points out that "our method of paying for new acquisitions through use of the earnings of the company being purchased has proved . . . satisfactory Each of the companies has been acquired without using Botany assets or incurring Botany obligations. . . ." *Id.* at 2, 3.

³²⁶ As is emphasized in Part I at 637, the use in the lease bootstraps of an express percentage agreement, where there are significant assets to be shielded from the operating risks of the business, is the practical equivalent of the issuance in the original bootstraps of notes guaranteeing a definite payment, by an entity with little or no assets.

³²⁷ See Murphy, *Sonnabend's Sackful*, *Fortune*, Sept. 1958, pp. 133, 135, where the inflated prices paid in the Botany Mills transactions are noted. Botany purchased Gurney Mills for \$14 million, almost twice what anyone else would offer for them. Most of the loss bootstraps involve what is an inflated price in fact, although, as in the original bootstraps, this fact may be difficult to prove in court, particularly inasmuch as close corporations are often involved. Whether or not price inflation can be proved, loss carryovers will not usually be purchased at their full tax value, inasmuch as they must be discounted to reflect their being available primarily in the future and to reflect the risks of not having income against which the carryovers may be offset; therefore, even in the absence of a provable "windfall" price, the transferee is to some extent benefited by another's loss carryovers. See notes 347-51 *infra* and accompanying text.

³²⁸ See *Knapp Bros. Shoe Mfg. Co. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956) (fair market value of business determined in good part by its success after the transaction).

inflated price does not lead to Owners' recapture of the business, eventually there will be a completed transfer of the business from them to New Company and Loss Group. Until then, Owners will continue to be the operating executives of the business and to receive its profits at capital gains rates for a considerable number of years. The use of net operating losses (which are attributable solely to the Loss Companies)³²⁹ to offset the income of Profit Company will enable Owners to pocket those profits more surely, in greater amounts, and in a shorter time than would be possible otherwise.

One claimed objective of the 1954 Code was to halt traffic in "loss shells"—corporations whose primary economic value lies in their accumulated net operating loss carryovers.³³⁰ The bootstrap aspects of these transactions appear to conflict with this policy: while in form there appears to be a purchase by Loss Group of Profit Company, in fact Owners retain such substantial ownership of it that they, and not the Loss Group, derive the primary benefit from the carryovers. In substance, Owners have purchased Loss Group's loss carryovers in return for twenty to twenty-five per cent of the income of the business and the possibility of Loss Group's acquiring ultimate ownership of Profit Company. And if the price should prove so great a burden that Owners recapture the business, they will have had the use of some of Loss Group's carryovers at a cost of about twenty-five per cent of the annual profits of the business.

Although Loss Group and New Company put up no money and assume no obligations or risks, they, like Charity in the original bootstrap cases, do not receive something for nothing. Loss Group and New Company paid for their acquisition of Profit Company by making available to Owners millions of dollars in net operating loss carryovers, at what frequently is a "windfall" price. For example, if the fair market value of Profit Company was \$4,000,000 and the agreed price was \$9,000,000, Loss Group was in effect "selling" \$5,000,000 of its loss carryovers, and thereby giving Profit Company's Owners a windfall. Loss Group has few assets and thus little bargaining power, but does not complain inasmuch as it is trading its loss carryovers for the ultimate ownership of the profit business. This appears to be the

³²⁹ S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954): "[a frequent abuse has been] the purchase of the stock of a corporation with a history of losses for the purpose of using its loss carryovers to offset gains of a business unrelated to that which produced the losses." H.R. REP. NO. 1337, 83d Cong., 2d Sess. 42 (1954), states with respect to the House version of § 382 (rejected by the Senate) which reduced the amount of the net operating loss carryover proportionately where 50% of the interest in a closely held loss corporation was acquired by new owners: "[the loss carryover is] a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss."

³³⁰ Implementation of this objective was attempted in §§ 172, 269, 381 and 382.

type of traffic in loss carryovers of which Congress has repeatedly disapproved,³³¹ and the frequently excessive price, giving Owners the use of Loss Group's carryovers at a windfall bargain, is but one more objection to these loss bootstrap transfers.³³²

The final link in the structure of the loss bootstrap is supplied when New Company, after its acquisition of Profit Company's stock, files a consolidated return with Loss Group. New Company thereby claims the right to offset the losses of the Loss Group against the unrelated postaffiliation income from the Profit Company business. The filing of a consolidated return injects new issues into the problem. In view of the substantial retention of ownership by the former owners of the profit business, does New Company have sufficient "direct ownership"³³³ of Profit Company's stock to constitute the "affiliation" required to file a consolidated return?³³⁴ Is the entire transaction such as to rebut the presence of the "business purpose" necessary for affiliation? And does the mere fact that a loss company had affiliated subsidiaries prior to the acquisition of the profit business justify a use of the losses of separate business enterprises—a use that the consolidated return regulations would not otherwise permit?

The Major Issues Presented

The loss bootstrap cases present three major issues. First, how far will a transfer be denied recognition as a "sale" for capital gains and other tax purposes where the Owners retain most of their original ownership rights?³³⁵ Second, to what extent may net operating loss carryovers be transferred among various business units and different Owners? Third, to what extent are these first two issues affected by the fact that they arise in the context of the filing of a consolidated return for an affiliated group of corporations?

³³¹ See S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 42 (1954); S. REP. NO. 627, 78th Cong., 1st Sess. 26, 58 (1943); H.R. REP. NO. 871, 78th Cong., 1st Sess. 24, 49 (1943).

³³² The objections to "windfall dealings" are discussed in S. REP. NO. 1622, 83d Cong., 2d Sess. 39, 228 (1954); ALI, *FEDERAL INCOME, ESTATE, AND GIFT TAX PROJECT—INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 41 (1958) [hereinafter cited as 1958 ALI STUDY]; ALI, *FEDERAL INCOME, ESTATE, AND GIFT TAX STATUTE—INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 44, 47 (1957-58) [hereinafter cited as 1957-58 ALI REPORT]; *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 876-77 (1959) [hereinafter cited 1959 *Advisory Group Hearings*] (statement of S. H. Rittenberg); 1959 *Advisory Group Hearings* 879 (statement of S. Barkin); Tarleau, *Difficulties Faced by Taxpayer Trying to Take Advantage of a Loss Carryover*, 4 J. TAXATION 91 (1956).

³³³ INT. REV. CODE OF 1954, § 1504.

³³⁴ INT. REV. CODE OF 1954, § 1501.

³³⁵ This issue has been discussed in detail in Part I with regard to the charitable bootstraps and will be further noted here only as necessary, recognizing that the bootstrap character of the transaction is woven through the other problems presented.

X. THE TRANSFERABILITY OF LOSS CARRYOVERS

Policy Considerations

The loss carryover and carryback provisions have been gradually extended until they now cover nine years, including a three-year carryback and a five-year carryover.³³⁶ The major argument advanced for these provisions is that because of the annual accounting principle and the statutory progressive tax rates, an individual who has \$10,000 of income in one year and no income in the next year will pay a higher total tax for the two years than will an individual with \$5,000 of income in each of the two years.³³⁷ The "inequity" of this result is usually conceded, and various proposals for "averaging" income or for the extension of the carryover and carryback technique, have been brought forth.³³⁸

The arguments in favor of averaging are, however, not as simple or conclusive as the example might indicate. If one accepts the Haig-Simons definition of income as the money value of the net accretion of economic power over a period of time,³³⁹ the current policy of taxing income only at the point of realization may in itself produce some degree of averaging. For example, while the discoverer of oil may experience a sharp increase in his economic net worth in the year of discovery, be-

³³⁶ Provisions for the carryover and carryback of losses have been contained in the Code since the Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1061 (1919), being eliminated by the National Industrial Recovery Act of 1933, ch. 90, § 218, 48 Stat. 209 and restored by the 1939 Code, added by ch. 247, § 122, 53 Stat. 867 (1939). See Tarleau, *The Place of Tax Loss Positions in Corporate Acquisitions*, in JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY—PAPERS SUBMITTED BY PANELISTS APPEARING BEFORE THE SUBCOMMITTEE ON TAX POLICY 610, 611 (Joint Comm. Print 1955) [hereinafter cited as 1955 COMPENDIUM]; H.R. REP. No. 855, 76th Cong., 1st Sess. 9 (1939). Recently, § 203 of the Small Business Tax Revision Act of 1958 increased the two-year carryback period to three years. INT. REV. CODE OF 1954, § 172(b) (1) (A).

³³⁷ See H.R. REP. No. 855, *supra* note 336, at 9: "New enterprises . . . are especially subject to wide fluctuations in earnings. . . . [A]llowance of a . . . loss carry-over will . . . stimulate new enterprise."

³³⁸ See SIMONS, PERSONAL INCOME TAXATION 153-56, 212-13 (1938); VICKREY, AGENDA FOR PROGRESSIVE TAXATION 164-97 (1947); Blough, *Averaging Income for Tax Purposes*, 20 ACCOUNTING REV. 85 (1945); Driscoll, *Income Averaging for Individual Income-Tax Purposes*, 1955 COMPENDIUM 175; Holt, *Averaging of Income for Tax Purposes: Equity and Fiscal-Policy Considerations*, 2 NAT'L TAX J. 349 (1949); Pechman, *A Practical Averaging Proposal*, 7 NAT'L TAX J. 261 (1954); Seidman, *Tax Averaging Plan*, 7 J. TAXATION 166 (1957); Steger, *On the Theoretical Equity of an Averaging Concept for Income Tax Purposes*, 13 TAX L. REV. 211 (1958); Taylor, *Some Reflections on Income Averaging and a Proposal*, 1959 DUKE L.J. 202; Vickrey, *Averaging, Cumulative Assessment and Retirement Income Provisions*, 1955 COMPENDIUM 871; a group of eight articles on averaging and the taxation of fluctuating income, 1 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM—COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 599-677 (Comm. Print 1959) [hereinafter cited as 1959 TAX REVISION COMPENDIUM].

³³⁹ HAIG, THE FEDERAL INCOME TAX 7 (1921); SIMONS, *op. cit. supra* note 338, at 51, 125.

cause of the realization principle he is taxed only over a period of years as he sells the oil. The net worth of a business may increase sharply during a single year, but the owners pay tax over a number of years only upon the receipt of salary and dividends. Similarly, an inventor may collect and be taxed on his patent royalties over a period of years even though his economic worth increased at the moment of invention.³⁴⁰ A second objection to averaging provisions is that most business and economic decisions involve a relatively short range process and emphasize short payoff periods. Therefore, ability to pay should be measured according to the short term concept of income upon which individuals generally base their behavior rather than, through averaging, upon lifetime or long-term periods.³⁴¹ Third, it is to some extent a principle of income taxation that deductions should be directly related to the income against which they are offset.³⁴² And finally, the anti-cyclical effect of progressive income taxation, derived from the premise that collections increase in prosperity and decrease in recession, would presumably be diminished if yearly taxes are leveled by averaging: taxes in prosperous years would be reduced by carrying over or back losses of less prosperous years.³⁴³

Despite these objections, averaging is among the few arguments for tax "relief" which find general acceptance. The most serious obstacle to adoption of averaging is its administrative complexity as compared to a strict annual accounting system. It is difficult enough to process millions of returns each year, without the added administrative, evidentiary, and legal burdens imposed by considering past and future years as well. Nevertheless, the idea that a workable averaging approach to taxation would be desirable receives broad support.³⁴⁴

³⁴⁰ See Steger, *supra* note 338, at 221-22. In another article, Steger makes an analogous argument that one's personal net worth increases sharply upon the acquisition of a professional education and that this increase is realized only over a full career. The analogy seems unrealistic, however, inasmuch as it is based on the value or "worth" of a person. Steger, *Lifetime Income Averaging: What It Means to the Professional*, 12 TAX L. REV. 427 (1957).

³⁴¹ See Slitor, *The Flexibility of Income Tax Yield Under Averaging*, 54 J. POL. ECON. 268 (1946); Steger, *supra* note 338, at 223-26.

³⁴² See S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954). An illustration of at least nominal implementation of this policy is found in the statutory limitations on the deductibility of losses incurred in so-called "hobby farming." See INT. REV. CODE OF 1954, § 270; Treas. Reg. § 1.270-1(b) (1959).

³⁴³ Conversely, it might be argued that the tax refunds obtainable in loss years through carrybacks to profit years will somewhat temper the effects of a recession or depression. See H.R. REP. NO. 2198, 85th Cong., 2d Sess. 5 (1958): "Your Committee believes that this current refund [as a result of increasing the two year carryback to a three year carryback], rather than subsequently reduced taxes, is particularly appropriate at the present time as a means of placing funds in the hands of business in a year when many of them are incurring losses." This argument seems, however, to assume that once funds are available in a depression year, they will be immediately spent and thus re-enter the stream of commerce.

³⁴⁴ See note 338 *supra*.

Averaging and the Transferability of Loss Carryovers

The transfer of loss carryovers involves more than mere averaging. At some point the transferee will so differ from the transferor—in terms of ownership, corporate entity or business operations—that the process will not be averaging but rather the use of a loss by a “different” taxpayer. The loss bootstrap cases illustrate that the more transferable a loss carryover becomes, the more clearly it provides tax relief not limited to mere averaging. The effect of the loss bootstrap transaction is to insulate the profits of a different taxpayer from taxation through carryovers acquired at bargain prices, as part of a plan whereby ordinary income is converted to capital gains.

The 1954 Code offers substantial evidence that carryovers are designed to permit more than simple averaging. Sections 122(c) and (d) of the 1939 Code provided that in determining the net operating loss deduction, depletion should be limited to cost rather than percentage depletion. The object of these provisions was to prevent the inclusion in loss deductions of items that did not really represent an “economic loss.”³⁴⁵ Cost depletion represents an actual outlay, while the excess of percentage over cost depletion is a mere subsidy.³⁴⁶ However, section 172 of the 1954 Code eliminates the adjustments previously required in order to ensure that the net operating loss deduction would represent economic losses; therefore, loss carryovers now include noneconomic subsidies as well as actual economic items. Thus, if a taxpayer had annual income of \$2,000, and a depletion deduction of either \$1,000 calculated on a cost basis or \$7,000 figured on a percentage basis, he is regarded under the 1954 Code as having a loss of \$5,000 which may be carried over, whereas under the 1939 Code he would have had economic income of \$1,000. Under the 1954 Code, then, the carrying over of losses becomes more than averaging; it is a process of distributing subsidies evenly.

³⁴⁵ Similar provisions were provided under the 1939 Code for tax-exempt interest. Int. Rev. Code of 1939, § 26(c) (2) (B), added by ch. 63, § 202(c), 58 Stat. 53 (1944). Thus, if a taxpayer incurred an operating “loss” of \$1,000 in a particular tax year but received \$3,000 of tax-exempt interest, his actual economic income would be \$2,000. To allow a \$1,000 loss carryover could hardly be construed as mere averaging.

³⁴⁶ There is little effort by the courts to limit or narrow the depletion deduction in any way, despite objections to its unfavorable effects both on the equity of our tax structure and on the concentration of wealth. See 105 CONG. REC. 7892-7914 (daily ed. May 21, 1959) (remarks of Senator Proxmire); Gray, *Percentage Depletion, Conservation, and Economic Structure*, 1955 COMPENDIUM 430; Gray, *Tax Reform and the Depletion Allowance*, 1959-2 TAX REVISION COMPENDIUM 979; Harberger, *The Taxation of Mineral Industries*, 1955 COMPENDIUM 439; Lubar, *A Plan for Tax Reform*, Fortune, March 1959, pp. 92, 236, 238; Rudick, *Depletion and Exploration and Development Costs*, 1959-2 TAX REVISION COMPENDIUM 983; *Hearings on Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 1-60, 177-219 (1950).

One of the major objections to the transfer of loss carryovers is that it permits persons with no economic relation to the loss to share in its benefits.³⁴⁷ This objection and the criticism of windfall transfers³⁴⁸ are concrete versions of the general policy against permitting deductions except against the income to which they are attributable. Continued dealings in loss carryovers also raise the issue whether "averaging" is not merely a tax myth behind which dealings in loss carryovers have become elaborated into an established set of commercial operations.³⁴⁹ This doubt is supported by the peculiar draftsmanship of the 1954 Code: while solemnly avowing the desire to stop the "peddling" of losses,³⁵⁰ Congress enacted a group of statutes that were, at the least, ineffective to halt the "peddling" of operating losses.³⁵¹

Other Policy Objections to Carryover Transferability

Where a loss company is utilized only for its loss carryovers, its previous business is frequently liquidated, leaving only a loss shell and often an accompanying decline in employment.³⁵² Dealings in loss carryovers have also encouraged mergers and similar corporate combinations,³⁵³ thus increasing the concentration of economic power.³⁵⁴

Arguments often advanced in support of transferability include, first, that unless loss carryovers can be transferred, a losing business will continue to operate when it would be more economical to terminate; the other side of this argument, however, is that the transferability of loss carryovers makes the dealing in loss companies to obtain their carryovers so lucrative that businesses which might have been continued or revived are sometimes liquidated unnecessarily with an obvious impact on employment and corporate concentration.

Second, it is argued that a loss corporation should be permitted to buy a profit business inasmuch as the rehabilitation of the losing

³⁴⁷ See *Woolford Realty Co. v. Rose*, 286 U.S. 319, 329-30 (1932), where Mr. Justice Cardozo points out that "a different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious."

³⁴⁸ See note 332 *supra* and accompanying text.

³⁴⁹ See Barkin & Perel, *Trafficking in Loss Corporations*, 104 CONG. REC. A4337 (daily ed. May 12, 1958). See also 1958 ALI STUDY 341-42, which questions the need or desirability of free transferability of losses in view of the deduction for investment losses, the loss carryback, and the fact that the losing business has paid no tax on its loss operations.

³⁵⁰ See note 329 *supra*.

³⁵¹ See text accompanying note 389 *infra*.

³⁵² See Barkin & Perel, *supra* note 349.

³⁵³ See 1958 ALI STUDY 342.

³⁵⁴ See Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957).

business is economically desirable.³⁵⁵ However, the practical effect in many circumstances may be less the "rehabilitation" of the losing business than tax dealing in its loss carryovers. The profit business that is acquired presumably could have continued to operate without being acquired by the loss business, although admittedly there is an economic advantage to the profit business in having portions of its income insulated from taxation through the use of loss carryovers. This advantage is passed on to Owners in the bootstrap transfers inasmuch as it makes possible payments to them that are larger, more assured and more frequent than would be possible otherwise. The rehabilitation argument is most valid where the loss business is an active, going concern and where the profit business acquired is not of disproportionate size. Under such circumstances, the issue is the desirability of the loss business's being able to keep going, or even revive, through the financing provided by the tax free income resulting from its ability to offset its carryovers against the income of the profit business. Such income is first available to, and benefits, the corporate enterprise, before it is distributed to Owners in the form of payments on the bootstrap "purchase" price. However, if deductions are regarded as appropriate only against the income of the economic activity that produced them, then to permit a carryover here is to provide a form of indirect government subsidy for loss businesses by letting them offset their carryovers against the income of a different economic activity.

But even this argument for transferability of loss carryovers loses its force under the circumstances characteristic of the loss bootstrap transfers. Unless the loss business is particularly vigorous, it will not be desirable to risk offsetting the income of the profit business by the continued losses of the loss business. Therefore, the losing economic activity will ordinarily be substantially reduced or terminated, or what is the equivalent, the loss company will be a shell, or will be acquiring a profit business substantially larger than itself. The tax advantages to be derived from such a transaction will be much more significant than any economic rehabilitation. Permitting such loss corporations to diversify by acquiring a profit business may not be as indicative of the Loss Business's economic revival as of the fact that it has sold its loss carryovers to Profit Company's owners at a windfall price, and has been paid a portion of the tax savings effected by Owners' subsequent receipt of the ordinary income of the business at capital gains rates.

Third, it is contended that permitting the unrestricted sale of loss carryovers would quickly reduce their prices to competitive levels, thus

³⁵⁵ See Tarleau, *Acquisition of Loss Companies*, 31 TAXES 1050, 1055 (1953).

eliminating the objection to windfall prices.³⁵⁶ While this, if true, may afford a justification for those who favor the free marketability of loss carryovers,³⁵⁷ it hardly meets the major objections to allowing *X* to purchase *Y*'s loss incurred in business *A* to offset against *X*'s income from business *B*.

Legal Approaches to Loss Carryover Transfers

Unlimited Transferability

The first and simplest legal approach³⁵⁸ is to permit the transfer of net operating losses without limitation.³⁵⁹ If this approach were accepted, dealings in loss shells would be unrestricted; and if the brisk market in loss companies of recent years is any indication, those transactions would ordinarily be at windfall prices. This approach does not attempt to restrict the use of losses to the persons, businesses, or entities that originally incurred them. While such a solution has the merits both of frankness and perhaps of coming closest to describing the actual pattern of decision, it would contribute to the current erosion of the progressive income tax by permitting taxpayer *X* to reduce his taxes by *Y*'s losses.

³⁵⁶ See Tarleau, *supra* note 332.

³⁵⁷ See Tarleau, *supra* note 332; 1959 *Advisory Group Hearings* 835 (remarks of Mr. Wolfman). According to Murphy, *supra* note 327, Wolfman is the chief architect of the loss bootstrap transaction. See Wolfman's Memorandum with Respect to the Availability of a Consolidated Net Operating Loss Carryover, Sale of Mattique Stock to Artistic Foundations, Inc., Before the Chief Counsel of the Internal Revenue Service (1958) (on file in Biddle Law Library, University of Pennsylvania). Cf. Tarleau, *supra* note 355. Compare INT. REV. CODE OF 1954, § 269(c) and ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954, REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 74 (1957), in *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. 2491 (1958), both of which permit loss transferability if the price is within certain limits.

³⁵⁸ The diversity of approaches to the transfer of loss carryovers reflects the absence of an effective, integrated solution. Among the many commentaries on this topic, in addition to those which have previously been noted, are Arent, *Current Developments Affecting Loss Corporations*, 35 TAXES 956 (1957); Arent, *The Impact of the Coastal Oil Decision Upon Loss Corporations*, 8 J. TAXATION 14 (1958); Cohen, Phillips, Surrey, Tarleau & Warren, *Internal Revenue Code of 1954: Carryovers Accumulated Earnings Tax*, 10 TAX L. REV. 277 (1955); Cuddihy, *Methods of Utilizing Loss Carryovers: Safe, Doubtful and Forbidden*, 8 J. TAXATION 72 (1958); Eldridge, *When Can a Successor Corporation Use a Predecessor's Loss?*, 8 J. TAXATION 46 (1958); Kirkpatrick, *Section 269 of the 1954 Code—Its Present and Prospective Function in the Commissioner's Arsenal*, 15 TAX L. REV. 137 (1960); Levine & Petta, *Libson Shops: A Study in Semantics*, 36 TAXES 445 (1958); Sinrich, *Libson Shops—An Argument Against Its Application Under the 1954 Code*, 13 TAX L. REV. 167 (1958); Williams, *Net Operating Loss Deduction*, 35 TAXES 93 (1957); Comment, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1394 (1958).

³⁵⁹ See Tarleau, *supra* note 332; 1957-58 ALI REPORT 43.

An Increase in the Carryback Period

Another proposal is to increase the usefulness of the loss to the corporation that suffers it by lengthening the carryback period to as long as five years.³⁶⁰ As the loss carryover and carryback periods now cover nine years, it is questionable how much further, if at all, they should be extended. Each extension precipitates a substantial revenue loss: the 1958 extension of the two year net operating loss carryback to three years was expected to result in a revenue loss of up to \$50,000,000 in the first year.³⁶¹ And additional carrybacks not only create increased administrative complications but also give little tax aid either to new corporations or to those with a string of loss years.

The Corporate Entity Approach

A third possible approach, upon which the early loss carryover cases placed almost exclusive emphasis, is to permit only the legal entity which incurred the losses to make use of them.³⁶² But while the factor of legal entity may have some reality in the case of the publicly held company which is an economic organization separate and apart from its shareholders, it is much less real with a closely held company. But as long as the close corporate entity is to be used, a shareholder should not be able at his option to deduct the corporation's net operating losses.³⁶³ However, to emphasize only the legal entity irrespective of continuity of business or of ownership is to engage in the kind of formalism that helped make dealings in loss carryovers possible.

The two extreme examples of judicial application of the corporate entity doctrine, *Alprosa Watch Corp.*³⁶⁴ and *Newmarket Mfg. Co. v. United States*,³⁶⁵ illustrate the rigidity of such a formal doctrine when it is applied to complicated tax problems such as the manipulation of corporate losses. In *Alprosa*, a glove corporation with an excess profits credit was purchased, its name changed, its business moved, the glove business discontinued, and the glove manufacturing assets sold. The purchasers then transferred to this corporate "shell" a shipment

³⁶⁰ 1958 ALI STUDY 342.

³⁶¹ See H.R. REP. NO. 2198, 85th Cong., 2d Sess. 2 (1958).

³⁶² *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Planters Cotton Oil Co. v. Hopkins*, 286 U.S. 332 (1932); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951).

³⁶³ *Cf. Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), where the Court emphasized that the choice of the advantages of incorporation as a method of doing business required also the acceptance of the accompanying tax disadvantages.

³⁶⁴ 11 T.C. 240 (1948).

³⁶⁵ 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957). It is surprising to note that the Commissioner sought certiorari in this case where he seemed clearly wrong but failed to do so in *D. K. Caldwell v. Campbell*, 218 F.2d 567 (5th Cir. 1955), where he seemed clearly right. See Part I at 640-41.

of watches that they were about to sell at a profit, and sought to deduct the prior excess profits credit from this profit. The government, seeking to disallow the credits, contended that the corporation had been purchased solely to evade or avoid taxes and that the transaction was unrealistic and served no business purpose. The Tax Court, however, held that the glove company, despite the changes in its name, location and business, was the same entity that earned the prior excess profits credit and therefore was entitled to use it. Such a formalistic application of the corporate entity doctrine could result in undue severity as well as unusual benefits to the taxpayer. In the *Newmarket* case, a Massachusetts corporation created a Delaware corporation and merged with it for the purpose of changing domicile; and except for domicile, the corporations were identical. The Commissioner argued that no carryback was permissible because the two corporations were separate entities. Emphasizing the realities the court rejected this argument.

The possible harshness of such insistence on the corporate entity test alone spurred the judicial creation of the fiction that where there was a "statutory merger" loss carryovers could be transferred on the theory that the resulting corporation continued the corporate entity of the merged corporations.³⁶⁶ But when an artificial doctrine is countered with another fiction, clarification rarely results. When overemphasis on the corporate entity was met with this merger doctrine, even more formal distinctions arose, such as the line drawn between a "statutory merger" to acquire a subsidiary, and the "liquidation" of the subsidiary into the parent.³⁶⁷

The Tax Avoidance Approach and Section 129

A fourth approach has been to emphasize "tax avoidance," or the dealing in loss companies primarily for their tax losses. The chief statutory weapon against this type of transaction was section 129 of the 1939 Code.³⁶⁸ Section 129 was intended to prevent certain manipulations of controlled entities as well as dealings in loss corporations.³⁶⁹ The legislative history of the section emphasizes that there must be a continuing business, implying that dealings in "loss shells" would not

³⁶⁶ *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939); *E. & J. Gallo Winery v. Commissioner*, 227 F.2d 699 (9th Cir. 1955); *Stanton Brewery, Inc. v. Commissioner*, 176 F.2d 573 (2d Cir. 1949); *Koppers Co. v. United States*, 134 F. Supp. 290 (Ct. Cl. 1955); but see *California Casket Co.*, 19 T.C. 32 (1952).

³⁶⁷ *Patten Fine Papers, Inc. v. Commissioner*, 249 F.2d 776 (7th Cir. 1957); *F. C. Donovan, Inc. v. United States*, 159 F. Supp. 1 (D. Mass.), *vacated and remanded*, 261 F.2d 470 (1st Cir. 1958); *Gramm Trailer Corp.*, 26 T.C. 689 (1956).

³⁶⁸ NOW INT. REV. CODE OF 1954, § 269. For convenience, "section 129" will be used to refer to both the old and new sections.

³⁶⁹ H.R. REP. No. 871, 78th Cong., 1st Sess. 24, 49 (1943); S. REP. No. 627, 78th Cong., 1st Sess. 26, 58 (1943).

be approved.³⁷⁰ Section 129 was an effort to provide a broad and flexible substance over form approach to various dealings in deductions, credits and allowances,³⁷¹ and in this respect it is similar to section 45.³⁷²

The Case History of Section 129

Much of the draftsmanship of section 129 is uncertain or faulty. It defined control by a rigid fifty per cent test rather than by a more flexible requirement directed at the substance of the relationship. It set up a subjective standard of "principal purpose to avoid or evade taxes" as its principal criterion. And rather than aiming language directly at the problem of loss peddling, the section was limited in its operation to only those cases where the *acquiring* of corporate control or corporate property was the vehicle of loss peddling. Nevertheless, the language of the section is sufficiently workable to have substantially reduced dealings in loss companies had the courts enforced it in the spirit in which it was enacted.

However, judicial formalism completely nullified section 129 for many years, particularly through the courts' failure to find the subjective "principal purpose" of tax avoidance.³⁷³ Another important formal limitation on section 129 was provided by a dictum in *Alprosa* which interpreted the statute as permitting disallowance of a deduction, credit, or similar item claimed by the acquiring corporation only when the item is attributable to the "acquired" corporation; but the "acquiring" corporation may not be deprived of deductions, credits, or similar items attributable to itself. Thus section 129 is avoided so

³⁷⁰ S. REP. NO. 627, *supra* note 369, at 60.

³⁷¹ The important provisions of § 129, essentially re-enacted by § 269, are: "If (1) any person or persons acquire . . . directly or indirectly, control of a corporation, or (2) any corporation acquires . . . directly or indirectly, property of another corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. . . . [C]ontrol means the ownership of stock possessing at least 50 per centum of the total combined voting power . . . or . . . of the total value (b) . . . [T]he Commissioner is authorized—(1) to allow . . . any part of any amount disallowed . . . if he determines that such allowance will not result in the evasion or avoidance of Federal income . . . tax for which the acquisition was made; or (2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured"

³⁷² See Part I at 669-74.

³⁷³ See S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41 (1954). Both reports comment that § 129 "has proved ineffectual . . . because of the necessity of proving that tax avoidance was the primary purpose of the transaction." While some of the § 129 cases here considered deal with tax deductions or credits other than operating losses, the principles involved in the application of the section do not turn on that distinction.

long as the loss company, even though a mere "shell," is the survivor of a merger.³⁷⁴ Such an emphasis on corporate entity, however, disregards the very loss peddling it facilitates. Analogous limitations on the statute were provided by holding that the tax deduction or credit at issue did not "stem from the acquired control,"³⁷⁵ or that the statute did not apply so long as a "business purpose" could be discerned.³⁷⁶

Surprisingly, however, some recent cases have enforced section 129 in something of the spirit in which it was enacted. *Coastal Oil Storage Co. v. Commissioner*,³⁷⁷ although not citing *Alprosa*, rejects its doctrine that deductions, credits or allowances may be disallowed under section 129 only to the "acquiring" and not to the "acquired" company. The Fourth Circuit emphasized that section 129 was applicable wherever the acquiring corporation obtained the benefit of an exemption or credit it would not have enjoyed except for the acquisition, even though the exemption or credit was derived from its own operations.

In *Mill Ridge Coal Co. v. Patterson*,³⁷⁸ the assets of a loss corporation engaged in coal mining were sold and the corporate shares transferred to new owners who thereupon used the corporation to engage in the oil transportation business. The Fifth Circuit, basing its decision on section 129 and the Supreme Court case of *Libson Shops, Inc. v. Koehler*,³⁷⁹ refused to permit a carryover of the net operating losses from mining to the new oil business.³⁸⁰ Several other decisions have joined this apparent renaissance of section 129.³⁸¹

³⁷⁴ T.V.D. Co., 27 T.C. 879 (1957); Wage, Inc., 19 T.C. 249 (1952), *acq.*, 1954-2 CUM. BULL. 6. See Arent, *The Impact of the Coastal Oil Decision Upon Loss Corporations*, 8 J. TAXATION 14 (1958); Cohen *et al.*, *supra* note 358, at 291-92.

³⁷⁵ Commodores Point Terminal Corp., 11 T.C. 411, 417 (1948), *acq.*, 1949-1 CUM. BULL. 1.

³⁷⁶ See *Commissioner v. Chelsea Prods., Inc.*, 197 F.2d 620 (3d Cir. 1952); Wage, Inc., 19 T.C. 249 (1952), *acq.*, 1954-2 CUM. BULL. 6; Berland's, Inc., 16 T.C. 182 (1951), *acq.*, 1951-2 CUM. BULL. 1; Alcorn Wholesale Co., 16 T.C. 75 (1951), *acq.*, 1951-2 CUM. BULL. 1; A.B. & Container Corp., 14 T.C. 842 (1950), *acq.*, 1950-2 CUM. BULL. 1. This "business purpose" doctrine is consistent with the general tendency to reject substance over form approaches on the grounds that the transaction is "not sham" or that it is "bona fide." Compare the treatment of § 45 discussed in Part I at 669-74, the sale and leaseback cases at 675, the thin capitalization cases at 660, and the original bootstrap cases at 639.

³⁷⁷ 242 F.2d 396 (4th Cir. 1957).

³⁷⁸ 264 F.2d 713 (5th Cir. 1959), *cert. denied*, 361 U.S. 816 (1959).

³⁷⁹ 353 U.S. 382 (1957). See note 384 *infra* and accompanying text.

³⁸⁰ While the District Court opinion in *Mill Ridge*, 58-1 U.S. Tax Cas. 9489 (N.D. Ala. 1958), was based only on *Libson Shops* and not on § 129, the court refused to follow A.B. & Container Corp., 14 T.C. 842 (1950), *acq.*, 1950-2 CUM. BULL. 1, which embodied the *Alprosa* "acquiring-acquired" distinction.

³⁸¹ See *British Motor Distribs.*, 31 T.C. 437 (1959), *rev'd*, CCH 1960 STAND. FED. TAX REP. (60-1 U.S. Tax Cas.) ¶ 9417 (9th Cir. March 31, 1960); *Elko Realty Co.*, 29 T.C. 1012, *aff'd per curiam*, 260 F.2d 949 (3d Cir. 1958); *American Pipe & Steel Corp.*, 25 T.C. 351 (1955), *aff'd*, 243 F.2d 125 (9th Cir.), *cert. denied*, 355 U.S. 906 (1957). And in *James Realty Co. v. United States*, 176 F. Supp. 306 (D. Minn.

The Continuity of Business Approach

Another approach, put forth as consistent with the general principle of permitting deductions to offset only income to which they are reasonably related, is to forbid the transfer of loss carryovers where "the income against which the offset is claimed was not produced by substantially the same business which incurred the losses."³⁸² However, under this approach problems of how to allocate the loss carryovers to old business income arise where old business assets are split up, as by a divisive reorganization, or where new business assets are acquired. This tracing problem is less difficult where a consolidated return is filed since, after affiliation, each business retains its separate corporate form.³⁸³ A second defect in the continuity of business approach is that it would deny a carryover upon a change of business even though there had been no change in the corporation or its stock ownership. Thus, it would prevent the type of economic rehabilitation achieved by shifting to a different line of business while allowing, in the case of a sale of the business, a windfall to accrue to the new owners to the extent that the existence of carryovers is not reflected fully in the purchase price.

In *Libson Shops*,³⁸⁴ sixteen retail clothing corporations and a management corporation, all owned by the same persons in the same proportions, were merged. The resulting corporation sought to deduct the prior year's losses of three of the retail corporations. These units did not have income in the year in issue, which was after the merger. The Supreme Court denied the carryover on the ground that "the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses"—a holding difficult to reconcile with the long line of cases from *New Colonial Ice Co. v. Helvering*³⁸⁵ to *Alprosa* and *Newmarket* which emphasize the corporate entity rather than business continuity.

1959), § 129 was applied to a corporate formation whereby a real estate development business was incorporated in multiple corporate form. Relying on the *Coastal Oil-Mill Ridge* rejection of the *Alprosa* doctrine, the court upheld the Commissioner's disallowance of surtax exemptions and excess profits credits, citing § 45 as providing additional strength for its position. This decision reflects a greater judicial inclination to look through the close corporate entity than has usually been found in the application of §§ 45 and 129.

³⁸² *American Trans-Ocean Corp. v. Commissioner*, 229 F.2d 97, 98 (2d Cir. 1956) (consolidated return situation).

³⁸³ The long delay in issuing the regulations under §§ 381 and 382 of the 1954 Code may be attributable to the difficulties involved in this allocation problem and in the question of what is "substantially the same business." In this connection, note Proposed Treas. Reg. § 1.381(a)-1(b)(2), 25 Fed. Reg. 756 (1960), published January 29, 1960, which provides that only a single corporation may be an "acquiring corporation" for purposes of § 381. "Acquiring corporation" is defined as the corporation which ultimately acquires, directly or indirectly, all the assets transferred.

³⁸⁴ 353 U.S. 382 (1957).

³⁸⁵ 292 U.S. 435 (1934); see note 362 *supra* and accompanying text.

The Continuity of Ownership Approach

Another major approach takes as its criterion the degree of continuity of ownership between the transferor and the transferee. Section 382(b) of the 1954 Code requires that after the transaction shareholders of a loss corporation hold at least twenty per cent of the outstanding stock of the acquiring corporation in order for the losses to be fully transferable.³⁸⁶ By this approach, the losses would not be transferable even if the business remained unchanged, the theory being that the new owners should not benefit from the losses of the old owners unless the old owners retain a substantial interest. On the other hand, losses could be offset against income from any new business activity—contrary to the continuity of business test and, to the extent that the interest of the old owners is emphasized, cutting across the corporate entity concept.

It is arguable that only that percentage of the loss carryovers should transfer as equals the percentage of old owners remaining.³⁸⁷ The lower the percentage of ownership required to be retained by the old owners, the more the new owners acquire a loss not attributable to their own economic activity. On the other hand, the larger the required percentage of retained ownership, the more difficult it will be for losses to transfer over, and minority shareholders may lose the benefit of the loss carryover. While this may be acceptable as one of the detriments that accompany the many advantages of using the corporate entity form, it is argued that without some transferability of loss carryovers, an uneconomic emphasis is placed on continuing a losing business so as not to lose the use of its loss carryovers.

Transfer of Loss Carryovers Under the 1954 Code

The 1954 Code combines most of the approaches previously discussed. Section 381(a) provides that there may be a transfer of net operating loss carryovers where one corporation acquires the assets of another corporation in certain section 332 liquidations, or in A, C, F, or certain D reorganizations.³⁸⁸ The general approval granted by section 381 is, however, limited by the provisions of section 382. Section 382(a) states that if any one or more of the ten largest stock-

³⁸⁶ Under § 382(b), the transfer of 5% of the loss carryover is denied for each percentage point below 20% of the stock of the acquiring corporation held by the shareholders of the old loss company. The 1957-58 ALI REPORT 50 would require that the owners of the old loss corporation acquire at least a 33% interest in the new corporation before losses would be transferable.

³⁸⁷ See H.R. REP. No. 1337, 83d Cong., 2d Sess. 42 (1954).

³⁸⁸ Section 381 does not apply to liquidations under § 332 where the basis of the assets distributed is determined under § 334(b) (2), or to B, E, and certain D reorganizations.

holders has, within a two-year period, increased his or their percentage of the outstanding stock by at least fifty percentage points, and the corporation has not continued to carry on a trade or business "substantially the same" as that conducted before the change in ownership of stock, then the net operating loss carryovers will not be transferable. Section 382(b) reduces the carryover by five per cent for each percentage point that the percentage interest in the acquiring company of the owners of the old loss company falls below twenty per cent after the transaction. Section 269(c) adds to section 129 of the 1939 Code the provision that if the consideration paid on any acquisition of control under section 269(a) is "substantially disproportionate" to the aggregate of the adjusted basis of the property and the "tax benefits" acquired, it shall be "prima facie evidence of the principal purpose of evasion or avoidance."

These provisions contain elements of each of the approaches noted above. The corporate entity theory is adopted by the 1954 Code insofar as loss carryovers presumably will not survive certain corporate dissolutions except pursuant to the specified reorganizations. Because the limits on transferability contained in section 382(a) refer only to acquisition of a loss corporation, it may be inferred that if a loss corporation "acquires" a profit company, the loss carryovers would be available by virtue of the entity theory. Inasmuch as this *Alprosa* loophole was so prominent a portion of existing law, one might conclude that Congress intended to leave it uncorrected. Any doubt as to the current availability of the *Alprosa* entity doctrine arises only because the courts have suddenly begun to enforce section 129.³⁸⁹ The continuity of ownership approach is reflected in the percentage of ownership provisions in sections 269 and 382. Section 382(a) incorporates the continuity of business approach in its provision that loss carryovers are extinguished upon certain purchases if the loss corporation has not continued to carry on substantially the same trade or business. The 1954 Code also purports to embody the approach centered on limiting tax avoidance by means of the re-enactment and amendment of old section 129, now section 269, as a weapon against dealings in loss corporations.

In fact, however, the 1954 Code may have weakened the previous statutory restraints on the traffic in loss companies.³⁹⁰ In the first place, section 172 deletes the reference to "the taxpayer" found in section 122 of the 1939 Code. This terminology was the starting point of the entity approach—artificial as it was, it at least put some limits

³⁸⁹ See note 381 *supra* and accompanying text.

³⁹⁰ See 104 CONG. REC. A4337-40 (daily ed. May 12, 1958) (extension of remarks of Representative Aime J. Forand).

on the traffic in loss carryovers. Deletion of this language would have been desirable if the 1954 Code had supplied alternative approaches designed to meet tax avoidance in this area.

Second, it would have been possible to redraft section 129 so that the statute eliminated the subjective "principal purpose" test, clearly covered both "acquiring" and "acquired" companies, improved the "control" test, and corrected the "gross income" language—in brief, deleted the language used by court decisions to negate section 129. None of this was done. Section 269(c) provides that if the price paid is substantially disproportionate to the aggregate of the adjusted basis of the property and of the "tax benefits" acquired, there is prima facie evidence of a principal purpose to evade or avoid. In other words, it is permissible to deal in tax losses themselves—the "tax benefits"—so long as the price is right.

Third, other portions of sections 269, 381 and 382 present an invitation to deal in loss companies. Sections 269(a) and 382(a), for instance, contain "50 per cent" control or ownership requirements. But it is as easy to achieve effective control with forty per cent as with fifty per cent. The very use of specific arithmetic figures usually facilitates tax avoidance plans. Similarly, the twenty per cent continuity of ownership rule set forth in section 382(b) will often offer little or no obstacle. If it is not convenient to give the shareholders of the loss company twenty per cent of the voting common stock of the transferee, they will get their twenty per cent in voting preferred stock; and if that also is inconvenient, there are other routes. For example, B reorganizations are excluded from the operation of section 381(a). A profit company therefore can acquire a loss company's stock in exchange for a small amount of its own stock, and the loss company will then be liquidated into the profit company. The chance of a court applying substance over form principles and holding such a transaction to be a "C" reorganization (which would make section 382(b) relevant) appear minimal in view of the current judicial tendency to ignore the doctrine of substance over form. Another and similar loophole, made possible by the loose drafting of sections 381 and 382, exists when a profit company (*X*) transfers a new business to a loss company (*Y*) in return for ninety per cent of *Y*'s stock. This device utilizes section 351, which also was "overlooked" by section 381, to permit *X* to purchase *Y* without being subject to the provisions of section 382(a).

Equally important, the 1954 Code not only eases the restrictions upon business dealings in loss carryovers but also weakens the only significant justification of loss carryover transferability—the averaging argument—by eliminating from section 172 the "economic loss"

limitations. This was done through the deletion of the provisions requiring, for example, that in computing loss carryovers the actual economic loss be taken into account by eliminating the effect of tax exempt interest and of the excess of percentage over cost depletion.

Other Proposals

One argument that has been urged against the transferability of loss carryovers is that sharp unemployment has often accompanied the liquidation of loss businesses as a part of the process of utilizing their loss carryovers.³⁹¹ Union representatives have urged that loss carryovers should be denied if a business is terminated at any time within three years after a change in ownership, where the former shareholders of the loss corporation have a less than fifty per cent interest in the corporation after either purchase or reorganization.³⁹² This proposal, however, would not preclude transferability, for example, where a forty per cent change in ownership is accompanied by a change in the business conducted; nor would it prevent relatively free transfer of loss carryovers whenever the business assets of the loss corporation are so insubstantial that it is worthwhile tax-wise to continue to operate the loss company for three years after acquisition. The answer to un-economic liquidations of loss businesses would appear to lie more in the enactment of proper restrictions on the transfer of loss carryovers, than in making the preservation of employment the criterion of transferability.

The Subchapter C Advisory Group recommends that where there is a fifty per cent change in ownership of the loss corporation, loss carryovers be limited to fifty percent of the consideration paid for the business.³⁹³ The Group contends that under such a rule the acquisition of the business, rather than the tax benefit of the loss carryovers, would necessarily be the primary objective of the transaction.³⁹⁴ The

³⁹¹ *Ibid.*

³⁹² See Statement of S. Barkin, *Hearings on General Revenue Revision Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. 3101-17 (1957). See also Barkin & Perel, *supra* note 349.

³⁹³ ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954, REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 567-73, 600-02 (1958) [hereinafter cited as 1958 ADVISORY GROUP REPORT], in *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 473 (1959).

³⁹⁴ Assuming a 50% corporate tax rate, this would require that at least three times as much be paid for the other assets of the business as for the tax advantages of the loss carryover: if there is a loss carryover of \$4,000,000 according to this formula \$8,000,000 would have to be paid for the business before the entire carryover could be transferred. And inasmuch as the carryover is worth only \$2,000,000 at the 50% tax rate, the business assets must be valued at \$6,000,000. The Advisory Group felt that this formula would prevent dealings in loss shells for the purpose of tax evasion or avoidance.

1958 *ALI Study*³⁹⁵ criticizes these proposals as directed only against "sham" transactions and against the acquisition of corporate "shells." While the proposals seem broad enough to limit some undesirable transfers of loss carryovers, the Advisory Group's philosophy that one is not really dealing in tax attributes if the greater part of the consideration is not paid for "tax benefits" is subject to question. Finally, the Group proposal fails to deal with the problem of the acquisition of profit businesses by loss corporations.

The Advisory Group also recommends amending section 269 to add the presumption that an acquisition is for the purpose of evading or avoiding taxes where the corporation does not continue to carry on "substantially the same" trade or business.³⁹⁶ But if a continuity of business test is really desired, it should be included specifically rather than by relying upon a "presumption" which might meet an uncertain judicial fate.

XI. AN INTEGRATED APPROACH TO LOSS TRANSFERS

Policy Considerations

In view of the limitations of the averaging rationale and the undesirability of allowing one man's income to offset another man's loss, loss transfers should be held to a minimum. In other words, whatever the merits of averaging, it should not be extended beyond the immediate taxpayer who incurred the loss. The reply to this conclusion is usually that one will lose one's own averaging power—the loss carryover or carryback—unless one can transfer losses. Even if this point were conceded, and with a nine year period in which to carry back and carry forward its force is limited, one's losses will not ordinarily be transferred at full value, as no one is likely to pay a full \$50,000 for \$50,000 worth of tax benefits. Therefore, even if the price is not set so low as to provide a "windfall,"³⁹⁷ the best of loss transfers will still result in the use of part of the loss carryover to offset another person's profit, in addition to the "recoupment" or averaging of one's own losses. For example, if a \$100,000 loss carryover is transferred for the equivalent of \$40,000, then \$40,000 is used to "average" the income of the taxpayer who incurred the losses, but \$12,000 is available to offset an outsider's profits, inasmuch as a \$100,000 carryover offers \$52,000 in tax benefits at a corporate income tax rate of fifty-two per cent. Where the transaction is at the windfall level—as when \$10,000 is received

³⁹⁵ At 343-45.

³⁹⁶ 1958 ADVISORY GROUP REPORT 573.

³⁹⁷ See note 327 *supra*.

for \$100,000 in carryovers—then averaging is so substantially an offset against the outsider's income that even the proponents of free transferability may hesitate.³⁹⁸

What would be the tax effects of restricting the transfer of loss carryovers as much as possible? Even if no loss carryovers could be transferred, the taxpayer would still get a capital loss on his stock investment. If the loss qualified as a loss on small business stock under section 1244 of the Code, the taxpayer could claim an ordinary loss on up to \$25,000 of his investment.³⁹⁹ And often the shareholder can use the option granted by subchapter S and offset an operating loss of the corporation against his own income. The existence of these possibilities limits the argument that the shareholder must be able to transfer his losses in order to recoup them. Furthermore, loss transfers will usually be offset against ordinary income, while the shareholder in the close corporation (for whom the loss transfer problem primarily arises) rarely pays more than a capital gains tax on his receipt of the corporation's earnings. Thus, the shareholder of a loss corporation seems to have adequate relief at present through: 1) a nine year period in which losses may be averaged; 2) a capital loss for his stock investment; 3) an ordinary loss for an investment of up to \$25,000 in small business stock; 4) the ability, in some circumstances, to utilize the loss himself by way of the option provided in subchapter S; 5) the ability, in many circumstances, to receive at capital gains rates the corporate income that is averaged by the deduction in full of loss carryovers at ordinary income rates; and 6) the ability to include in loss carryovers not merely economic losses but also the effect of items such as percentage depletion or tax-exempt interest, whose effect can thus be spread over several tax years. These factors suggest that there is no need to permit further loss transfers, whether in the form of loss "shells" or loss bootstraps, or through more legitimate averaging techniques.

Even if it be concluded that losses should be available only to the taxpayer who incurred them, the practical problem remains of determining who that taxpayer is. Most of the approaches considered have emphasized only a single factor as the basis for determining the identity of the taxpayer eligible for a loss transfer. The factors stressed have been the degree of continuity of ownership, the degree of continuity of business, the degree of continuity of legal entity, or the degree of

³⁹⁸ Although he otherwise advocates the free transferability of tax losses, Tarleau concedes that to allow free trade in tax losses during a depression period would so endanger the revenues that it would not be possible to allow the transfer of loss shells. See Tarleau, *Difficulties Faced by Taxpayer Trying to Take Advantage of a Loss Carryover*, 4 J. TAXATION 91 (1956).

³⁹⁹ Up to \$50,000 may be claimed as an ordinary loss by a husband and wife filing a joint return.

"tax avoidance" present in a particular transaction. It is perhaps characteristic of tax jurisprudence that most of these approaches assess neither the entire relationship presented nor all pertinent policy considerations; only an occasional decision emphasizes a combination of factors, rather than a single variable.

The disadvantages of relying on legal entity alone have been demonstrated. But continuity of ownership and continuity of business are also not self sufficient criteria. The real issue is whether there is sufficient overall continuity between the person incurring the losses and the person seeking to make use of them, so that the former's losses are being averaged rather than used to offset the latter's income. Continuity of business as a sole standard is not sufficient to meet that issue, for if business assets are sold, and no more, the loss carryovers should not accompany the assets even though the "business activity" continues. Nor will mere continuity of ownership suffice: if all the stock of a corporation is sold, and no more, the new owner rather than the old owner should benefit from the previous losses. And "tax avoidance" turns on whether the transaction was characterized by a mere dealing in tax attributes, which in turn is a corollary of the degree of continuity. The loss shell situations all involve cases where the only continuity lies in the presence of the same entity and both the business and the ownership have changed—the mark of avoidance is the absence of sufficient continuity to warrant offsetting losses against another's income.

A Theoretical Solution

If the basic principle of taxing income to the person and business activity earning it, and at progressive rates, were rigidly adhered to, the only logically permissible deductions would be those attributable to the costs of earning income. As various tax commentators have pointed out, the numerous types of personal deductions are, in theory, inconsistent with these principles of progressive income taxation and are, as such, a source of tax erosion.⁴⁰⁰

⁴⁰⁰ See Blum, *The Effects of Special Provisions in the Income Tax on Taxpayer Morale*, 1955 COMPENDIUM 251; Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955); Groves, *Special Tax Provisions and the Economy*, 1955 COMPENDIUM 286; Hellmuth, *Erosion of the Federal Corporation Income Tax Base*, 1955 COMPENDIUM 888; Hess, *The Gentle Art of Tax Avoidance*, The Reporter, April 16, 1959, p. 12; Lubar, *A Plan for Tax Reform*, Fortune, March 1959, p. 92; Mills, Curtis, Ruttenberg, Heller, Rudick, Thomson, all in Mills & others, *What Can We Do About Taxes*, Fortune, July 1959, p. 90; Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203 (1956); Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1 (1957); Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815 (1958); Thompson & Silberman, *Can Anything Be Done About Corporate Taxes?*, Fortune, May 1959, p. 121; *Hearings on the General Revision of the Internal Revenue Code Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. (1958); and see the group of articles appearing in the 1959 TAX REVISION COMPENDIUM at 1-167.

Strict consistency with the theory that only deductions representing the costs of earning income should be allowed would demand that loss transfers be denied except as offsets against the income created by the economic activity incurring the loss. But one of the reasons for the confusing multiplicity of approaches to the treatment of loss carryovers is that tax theory is not fully articulate as to whether such income is to be attributed to a particular economic activity or to the owner of the income engendered by that activity. If a policy of rigidly limiting loss transfers is to be applied, both possibilities must be accorded weight: a loss transfer should be denied except to the original owners of the economic activity that produced the loss. Where there is a percentage change in ownership, the loss transfer should be reduced correspondingly or, in one view, eliminated where the percentage change has exceeded the point of effective control. But whatever the theoretic merits of so rigorous an approach and whatever its desirability, it would not currently be acceptable even though it is now partly mirrored in the consolidated return regulations and in the language of *Libson Shops*. This theoretical approach does, however, indicate the framework of the loss carryover problem.

A Practical Formula for Determining Loss Transferability

It is submitted that there is available a rough formula to bridge the gap between theoretical solution and practical implementation—in any loss transfer situation, it may be concluded that the end result is averaging one's own income and not offsetting another's income, if there is substantial continuity of any *two* of the *three* factors of ownership, legal entity, and economic activity (business). Under this formula, there are eight basic situations to be considered.

For example, if (1) there is a change in the business and a change in ownership but the legal entity remains the same, there exists the typical loss shell situation exemplified by *Alprosa* and proscribed as tax avoidance by section 269. On the other hand, if (2) the business and ownership remain the same but the legal entity is changed, two factors remain constant and the loss transfer should be and is permissible, as *Newmarket* demonstrates. If (3) ownership changes but the business and legal entity remain unaltered—as when all the stock of a corporation is sold—it is clear that the loss would run with the combination of the business and the legal entity (two factors) and would not remain with the old owners. But if (4) both the business and the entity change while the ownership remains the same, the factual situation of *Libson Shops* exists and transferability is denied.

Where (5) the ownership and the legal entity continue but there is a change in the business, transferability might seem permissible on the ground that a corporation, like an individual proprietor, should be able to change its business without losing the averaging benefits of prior losses. This is the most difficult application of the formula and is the point where it deviates from the theoretical solution set forth above in that it permits the loss carryover to be utilized. Conversely, however, where (6) ownership and the legal unity are changed, two factors have not remained continuous and thus transferability should be denied. In other words, if business assets are sold, operating losses will not go with them.

Where (7) there is a change in the business, the ownership and the entity, it would seem that offsetting rather than averaging would result. This answer conflicts, however, with section 382(b) where changes in the business, in the legal entity, and in eighty per cent of the stock ownership are permitted without destroying the carryover. Where (8) the situation is reversed and the business, ownership and legal entity remain continuous, the only policy issue is the desirability of averaging and not the question of loss transfers.

Despite the simplicity of this "two factor formula," there is nothing magical or conceptual about it. It is a reflection of the complexities introduced by the artificial entity doctrine and its assumption that a legal entity is a person like anyone else. The peculiar division which this doctrine produces between economic reality and legal result indicates that reliance on the entity concept alone could produce only artificiality in the loss transfer area—and so it did. But the two factor formula, by combining the entity approach alternatively with one of the two prevailing notions of the economic right to a loss—either that losses should go with the economic activity that produced them, or with their original beneficial ownership—achieves a reasonable degree of reality in distinguishing permissible averaging from prohibited offsetting. This is not meant to suggest that the formula can or should be mechanically applied; the real question remains the total relationship between the loss, its source and its transferee. But the formula, if used in the light of the policy approach recommended, may help clarify what has been a confused area.

Reasoning from the policy conclusion that taxpayers already have available so many forms of averaging that loss transfers should be kept to a minimum so as to reduce the possibility of offsetting an outsider's income, it follows that the two factor formula should be applied by placing the burden of proof on the taxpayer. Specifically, if a necessary factor is that substantially the same business is being conducted, many

difficulties arise in seeking to trace through and allow loss carryovers only against the income from the old business. Particularly is this true where the business assets are split or new assets acquired.⁴⁰¹ The strict answer is that the taxpayer should have the burden of so segregating assets and their related income as to meet the requirements for a loss transfer.⁴⁰² If he cannot do so, then he will still be able to utilize the other forms of averaging available to him. Inasmuch as the Code itself adopts the "substantially the same business" criterion in section 382(a), Congress obviously did not consider it too complicated a standard to be applied; certainly it is no more difficult than attempting to value a closely held corporation. Such problems of proof are typical of the effort to get at the substance of any complex legal-factual situation.

In harmony with this strict approach, "change in ownership" should be defined restrictively, so as to include a transfer both of effective control, irrespective of the percentage of stock changing hands, and of a fixed minimum percentage of stock whose transfer would be treated as signifying in any event a change in ownership.⁴⁰³ If the economic benefit of ownership of the losses is viewed as more significant than control of the company, an alternative formulation might reduce the loss deduction in proportion to the percentage reduction in the interest retained by the old owners.

There is, however, at least one situation where the two factor formula may not be adequate to prevent the offsetting of one person's income against another person's losses, namely, where a loss company acquires a profit business or a group of them, in order to offset its own losses.⁴⁰⁴ From the standpoint of ownership, the loss company is averaging its own losses against its own income. But if the idea that income from one economic activity should not be available to offset the losses from another is stressed, the result becomes more doubtful. Briefly, if there is a substantial change in economic activity alone, may there be any loss transfer? In strict theory, a loss transfer should be

⁴⁰¹ See Levine & Petta, *supra* note 358; 1958 ALI STUDY 346-48; Sinrich, *supra* note 358; 1958 ADVISORY GROUP REPORT 568: "[The continuity of business test in *Libson Shops*] . . . would result in too narrow a rule, not in harmony with the general carryover scheme of the statute, and . . . very difficult to draft and apply."

⁴⁰² The Commissioner has taken a very similar position with respect to the treatment of loss carryovers and carrybacks under the 1939 Code. See Rev. Rul. 59-395, 1959 INT. REV. BULL. No. 51, at 20, which permits certain net operating losses to be offset only against the income of the assets to which they are attributable. This would seem to put the burden of proof on the taxpayer.

⁴⁰³ Cf. H.R. REP. No. 1337, 83d Cong., 2d Sess. 42, A142-43 (1954), which so provided upon a 50% or more change of ownership in a close corporation, but made that its sole test.

⁴⁰⁴ This is the fifth situation discussed above.

denied on such facts; consistent with this view, the consolidated return regulations⁴⁰⁵ do not permit the offsetting of preaffiliation losses from one economic activity (an unaffiliated corporation) against the post-affiliation income from another (an affiliated group or unaffiliated corporation). On the other hand, if the owner of the corner barber shop loses money and buys a grocery store against whose income he offsets his losses, ownership rather than economic activity is likely to be emphasized.⁴⁰⁶

The conflict over whether a change in business alone should destroy loss transferability is mirrored in *Libson Shops*, cited above as a variant of the two factor formula; but it is not fully clear exactly what *Libson Shops* held in the context of the formula.⁴⁰⁷ The facts included a change in two factors: business and entity. However, the language of the decision stressed only the former factor—that the losses of one business may not offset the income of another. *Libson Shops* may mean that there can be no deduction of losses except against the income of the economic activity which produced them, even though there is continuity of ownership and entity. If so, it applies the philosophy of the consolidated return regulations and of the theoretic approach stated above. Such a strict rule would tightly restrict the transferability of losses, which probably explains the terror *Libson Shops* inspired, and the ensuing efforts to neutralize it.⁴⁰⁸

In general, the two factor approach is workable even under present legislation. It is most at variance with section 382(b), which permits a loss transfer despite changes in the business, in the legal entity, and in eighty per cent of the stock ownership. Section 382(b) is a product of one-factor conceptualism⁴⁰⁹ and therefore amendatory legislation may be desirable. Section 382(a), however, does embody a two factor approach: continuity of business and continuity of ownership. If that section's criterion for determination of a change in ownership were

⁴⁰⁵ Treas. Reg. § 1.1502-31(b)(3) (1955).

⁴⁰⁶ But it is not clear that a sole proprietor may automatically offset losses from one economic activity against profits from another. If the losses derived from a "hobby farm," a different result might obtain. See note 342 *supra*.

⁴⁰⁷ Levine & Petta, *supra* note 358, argued that the only function of the continuity of business test in *Libson Shops* was to decide whether the merged corporation was the entity that sustained the premerger losses. However, the Supreme Court's opinion appears to lay a broader emphasis on changes in business as an important factor in determining the transferability of losses.

⁴⁰⁸ Tobolowsky, *New Cases Limit Changes in Ownership and Operations That Preserve Carryovers*, 12 J. TAXATION 8 (1960), comments that in the drafting of the regulations under § 382, consideration is currently being given by the Internal Revenue Service to taking the position that *Libson Shops* requires that no transfer of a loss carryover be permitted if a corporation changes from the garage to the laundry business, even though there is no change of entity or ownership.

⁴⁰⁹ Note that the American Law Institute, in both its 1957-58 ALI REPORT 50-51 and its 1958 ALI STUDY 361-64, recommends percentage-of-ownership tests.

redrafted so as to be more flexible and more workable, and if its definition of "purchase" were expanded so as to cover the type of transaction involved in the loss bootstraps, it would be reconcilable with the two factor formula. Section 269, as originally conceived, emphasized the type of substance over form approach that lies behind the two factor formula. The section is an application of one variant of the formula—changes in ownership and business; as previously noted, however, re-drafting is necessary to remove the language which has proven vulnerable to judicial formalism.⁴¹⁰

In summary, the two factor formula provides a clear solution for all but one situation—the instance where the only change is in economic activity. There, in theory, policy argues for the denial of transferability; short of that, the two factor formula provides a reasonable compromise.

XII. LOSS TRANSFERABILITY AND THE LOSS BOOTSTRAPS

The Loss Bootstrap and the Various Approaches to Loss Transfers

The loss bootstraps do not seem to meet the requirements of any of the major approaches to the transferability of loss carryovers, with the obvious exception of the theory that carryovers may be freely transferred. In the loss bootstrap situation, Profit Company is acquired by a thinly capitalized corporation, newly organized by a group of loss companies which are affiliated in the filing of a consolidated return and which have large net operating losses. But the loss bootstrap, rather than satisfying any two of the elements of the two factor formula, does not, in substance, comply with any: there is no continuity of business, entity, or ownership. Practically speaking, Loss Group is not currently purchasing the profit business through its asset-poor subsidiary; nor, in view of Owners' retention of ownership, will such a "purchase" ordinarily be completed during the life of the loss carryovers. As analysis of the bootstrap transaction has shown, Owners of Profit Company are in substance purchasing Loss Group's carryovers at a windfall price. Inasmuch as Owners have no ownership relation to Loss Group, the losses will primarily be used by an entity and owners other than those who incurred them. And the loss business is usually liquidated, thus eliminating any continuity of business and arousing those objections to the transfer of loss carryovers which center on corporate concentration and unemployment.⁴¹¹

⁴¹⁰ See notes 371-75 *supra* and accompanying text.

⁴¹¹ See notes 390-92 *supra*.

The transaction is equally in conflict with the approach that centers on "tax avoidance" and with the somewhat related position that if tax benefits are to be transferred, a fair and not disproportionate price shall be paid. Inconsistency with the latter approach is shown by the windfall price characteristic of the loss bootstrap. And the fact that Owners do not even acquire a loss "shell," which acquisition itself would be proscribed by section 129, but rather deal directly in the tax attributes (the loss carryovers) is a significant manifestation of "tax avoidance." Thus the loss bootstraps conflict with every major approach which seeks to limit loss transfers.

The Relevance of Libson Shops Under the 1954 Code

If *Libson Shops* is interpreted as requiring a change in both business and entity, the two factor formula incorporates the approaches stated in both section 269 and in that case. But the clamor that arose over the Supreme Court's decision in *Libson Shops*⁴¹² culminated with the Commissioner's abandonment of the victory won⁴¹³ even though, at most, it embodied the very philosophy set forth in his own consolidated return regulations. Notwithstanding the fact that *Libson Shops* emphasized the term "the taxpayer" which appeared in old section 122 but was deleted from section 172, it is reasonable to regard the case as relevant under the 1954 Code, particularly if it is interpreted as requiring changes in entity as well as business. The stricter position—that only a change in business is required to deny the transferability of losses—though sound in theory, is more difficult to reconcile with the Code.

Sections 381 and 382 were primarily designed to eliminate the confusion as to the role of the corporate entity concept.⁴¹⁴ They permit a loss transfer without compelling resort to fictions such as that a merger

⁴¹² See note 401 *supra*.

⁴¹³ See Rev. Rul. 58-603, 1958-2 CUM. BULL. 147; Rev. Rul. 59-395, 1959 INT. REV. BULL. No. 51, at 20. It is a further commentary on the contribution of the administrative process to tax erosion that after the Commissioner won *Libson Shops* in the Supreme Court, he was compelled to back down by pressures exerted by groups representing the tax bar. Note, however, that some language in Rev. Rul. 59-395 implies that the *Libson Shops* principles will be invoked at certain points under the 1954 Code. This language probably reflects the refusal of the professional staff to accept the complete abandonment of the *Libson Shops* principle. The last few lines of the Revenue Ruling suggest that the Service may attempt to apply the continuity-of-business doctrine under §§ 269 and 382(b), and to bear down heavily on the requirement of a "business purpose" for any reorganization transactions involving a loss carryover. See note 408 *supra*.

⁴¹⁴ S. REP. No. 1622, 83d Cong., 2d Sess. 52 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 41 (1954). ". . . [W]hether or not the items carry-over should be based upon economic realities, rather than upon such artifices as the legal form of the reorganization . . . the new rules enable the successor corporation to step into the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under Court-made law The new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as liquidation and reincorporation or merger into another corporation"

corporation is the same entity as its predecessors,⁴¹⁵ and without confronting the transfer with the contrasting rigidities of *New Colonial Ice* or of *Newmarket*. But this elimination of the entity obstacle to loss transfers hardly means that sections 381 and 382 dispense with the continuity of ownership, the continuity of business, or the avoidance tests.⁴¹⁶ In any event, the two factor interpretation of *Libson Shops* appears relevant to situations not specifically covered by sections 381 and 382, and this is perhaps also true of the view that only a change in business is required to invoke the prohibitions of *Libson Shops*. By either view, however, an application of *Libson Shops* to the loss bootstraps would deny deductions of loss carryovers: Loss Company's business is liquidated⁴¹⁷ and there is a change in entity as well as ownership. Revenue Ruling 58-603⁴¹⁸ only declines to apply *Libson Shops* to only certain transactions under section 381 of the 1954 Code;⁴¹⁹ and Revenue Ruling 59-395⁴²⁰ makes this position more specific. Even if *Libson Shops* were to be regarded as inapplicable, continuity of business remains relevant under either section 269 or the two factor formula, just as it is for the direct application of section 382.

The Effect of Sections 269, 381 and 382

The 1954 legislation does not approve every loss transfer that is not specifically barred by section 382. The enactment of section 269 indicates that some limitations on the transfer of losses outside of those covered by sections 381 and 382 were intended—the fact that sections 381 and 382 significantly reduce the importance of the corporate entity criterion in itself strengthens section 269. Cases by-passing section 269 relied primarily on the theory that the loss “belonged” to the corporate entity or corporate shell. The legislative tests of loss transferability,

⁴¹⁵ The fact that § 381 omits B and E reorganizations, which present no entity problem, is further support for this view.

⁴¹⁶ No separate “tax avoidance” test is necessary under the two factor formula. By definition, any situation in which only one factor is retained involves “offsetting” of income, and so tax avoidance.

⁴¹⁷ MOODY'S INDUSTRIAL MANUAL 2642 (1957) states that Botany Mills, Inc. disposed of its last textile operation in 1955, not long after the acquisition.

⁴¹⁸ 1958-2 CUM. BULL. 147. *Accord*: Rev. Rul. 59-395, 1959 INT. REV. BULL. No. 51, at 20. See note 413 *supra*.

⁴¹⁹ The ruling states: “The principle announced [in *Libson Shops*] will not be relied upon . . . under the Internal Revenue Code of 1954 as to a merger or any other transaction described in section 381(a) of the 1954 Code. However, see sections 382(b) and 269” (Emphasis added.) Presumably, therefore, wherever § 381 does not apply, *Libson Shops* is still available. It is typical of the orientation of most tax literature that the commentators are virtually unanimous in rejecting with alarm the thought that *Libson Shops* could be relevant under the 1954 Code. However, even though the two Revenue Rulings cited in notes 413 and 418 *supra* are very “liberal” with the revenues, it seems clear that the Commissioner will apply the *Libson Shops* principle under the 1954 Code in a number of situations.

⁴²⁰ 1959 INT. REV. BULL. No. 51, at 20.

however, were not intended to be limited to the question of strict compliance with sections 381 and 382. The legislative history indicates that the Congressional purpose was to prevent the use of loss corporations "to offset gains of a business unrelated to that which produced the losses"⁴²¹ and to prevent traffic in loss carryovers.⁴²²

However, many types of transactions were omitted from the coverage of sections 381 and 382,⁴²³ or will escape their limitations because of the way those sections are drafted.⁴²⁴ Unless section 269 is applied in the realistic manner of *Coastal Oil and Mill Ridge*, sections 381 and 382 may serve to forward the very dealings in loss shell corporations that they purport to prevent.

Many of the section 381 and 382(b) transfers involve reorganization transactions, which must ordinarily reveal a "business purpose" to be approved as reorganizations.⁴²⁵ Therefore, it is appropriate to interpret sections 381 and 382(b) as including a business purpose requirement;⁴²⁶ such a view is also consistent with section 269.⁴²⁷ There will still, however, be loss peddling situations not covered by either the business purpose doctrine or the rather limited wording of section 269. In such cases, a substance over form approach like the two factor formula should be applicable. This is particularly true of the loss bootstrap cases, which do not literally fall within sections 381 and 382. In form, a loss bootstrap is the acquisition of Profit Company by Loss Group, a situation not covered by sections 381 and 382; in substance, Owners and Profit Company are purchasing, at a windfall price, part of Loss Group's loss carryovers via New Company. Even

⁴²¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954).

⁴²² H.R. REP. NO. 1337, 83d Cong., 2d Sess. 42 (1954).

⁴²³ E.g., B and E reorganizations; certain § 332 liquidations; § 351 formations; consolidated return situations; and acquisitions of profit corporations by loss corporations.

⁴²⁴ For example: using preferred stock in order to meet the 20% continuity test of § 382(b); achieving effective control through purchases below 50%; waiting two years to change the business; purchasing 50% of the stock of a subsidiary, changing its business, and then liquidating under § 332; purchasing 50% of the stock of a loss corporation and 80% of the parent corporation and merging on a four-to-one share basis; or acquiring a loss corporation through the issuance of small quantities of stock followed by liquidation.

⁴²⁵ *Gregory v. Helvering*, 293 U.S. 465 (1935).

⁴²⁶ Against this view is the fact that certain § 332 liquidations are also included in §§ 381 and 382(b). Ordinarily a "business purpose" doctrine is not applied to such liquidations.

⁴²⁷ But cf. S. REP. NO. 1622, 83d Cong., 2d Sess. 284 (1954): "If a limitation in this section [§ 382] applies to a net operating loss carryover, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carryover." This would make it possible to by-pass § 269 merely by giving the old owners a 19½% interest whenever the transaction is covered by § 382(b). Section 382(b) reduces the available carryover by 5% for each per cent that the retained interest of the old owners drops below 20%. Here, protection from § 269 could be obtained at a cost of only 2½% of the total carryover. It is expected that the Internal Revenue Service will disregard the suggestion, which is nevertheless interesting as an example of an overt attempt to reshape legislation through the unpublic processes of writing legislative history.

by this analysis, the loss bootstrap still does not appear to be covered by the limitations in section 382 as it is not a reorganization or other type of transaction covered by section 382(b).⁴²⁸ Nor are the strictures of section 382(a) available, inasmuch as ordinarily fifty per cent of the stock of Loss Group is not purchased.

Even section 269 does not appear to apply literally to those loss bootstraps whose planners were careful not to acquire fifty per cent of the stock of the Loss Companies. However, in view of the recent rejection of the *Alprosa* doctrine by *British Motor Distribs.*, *Coastal Oil* and *Mill Ridge*, it can be argued that when the Loss Group formed New Company as a controlled subsidiary, it was thereby getting the "benefit" of Loss Group's loss carryovers in a way otherwise unavailable. It can also be contended that when New Company acquired over fifty per cent of the stock of Profit Company, it thereby came within the *Coastal Oil* interpretation of section 269. Furthermore, the total effect of the transactions whereby Loss Group acquired New Company and New Company acquired Profit Company is such as to come within the coverage of section 269, particularly as *Alprosa* is no longer good law.⁴²⁹

Whether or not its formalities bring it within section 269, a loss bootstrap is not the type of transfer specifically authorized by section 381, and sections 381 and 382 should not be interpreted to permit any loss transfer to which they do not expressly apply, particularly where the transfer is in violation of their claimed policy against dealing in loss carryovers. This conclusion is in accord with the view that sections 381 and 382 were intended only to cure the problems posed by the entity concept, and not to authorize the free transferability of losses.

The Loss Bootstraps and Consolidated Returns

Bootstrap Retention of Ownership

Under the consolidated return regulations,⁴³⁰ only affiliated groups may have the privilege of filing consolidated returns. Section 1504(a)

⁴²⁸ See the discussion in Part I at 667-68, pointing out the inadequacy of describing the original bootstraps as "reorganizations." The loss bootstrap device resembles the lease bootstrap in lacking a formal instrument readily subject to being labeled "stock."

⁴²⁹ The approach to § 269 represented by *Mill Ridge* and *Coastal Oil* is increasingly established in tax jurisprudence. The Tax Court in the recent case of *British Motor Distribs.*, 31 T.C. 437 (1959), reaffirmed all of the formal concepts of *Alprosa*, including the "acquired-acquiring" dichotomy. *Accord*, *Virginia Metal Prods.*, 33 T.C. 88 (1960). *But see* *James Realty Co. v. United States*, 176 F. Supp. 306 (D. Minn. 1959), which expressly declined to follow *British Motor Distribs.* and the Ninth Circuit has now reversed the Tax Court in the latter case, CCH 1960 STAND. FED. TAX REP. (60-1 U.S. Tax Cas.) ¶ 9417 (9th Cir. March 31, 1960), adopting the *Coastal Oil* approach. The Tax Court position is increasingly isolated.

⁴³⁰ Treas. Reg. § 1.1504-1 (1955).

defines an "affiliated group" as one or more chains of includable corporations, eighty per cent of whose stock is owned directly by one or more of the other corporations, and whose common parent corporation also owns directly at least eighty per cent of the stock of at least one of the other includable corporations. The requirement of direct ownership of eighty per cent of the stock for affiliation makes explicit what is inherent in the privilege of filing consolidated returns: a parent must have sufficient ownership of a subsidiary to ensure that the group will have a degree of economic integration that justifies the consolidation of returns. But the bootstrap analysis suggests that Owners have retained so much of the ownership of Profit Company that New Company cannot be seen as holding much more than a bare legal title pending exhaustion of the loss carryovers. A holding that such title or its equivalent constitutes the degree of ownership⁴³¹ necessary for affiliation is inconsistent with the requirement of substantial integration of parent and subsidiary that underlies the privilege of consolidated returns,⁴³² and would facilitate tax avoidance because of the opportunity for manipulation when a mere formality constitutes "consolidation." But the principle has been frequently proclaimed that the consolidated return regulations were not intended to facilitate tax avoidance or to grant any tax advantage not otherwise available.⁴³³

⁴³¹ In some loss bootstrap situations, the stock of the profit company is placed in escrow pending the completion of the payments. Authorities are then cited which state that putting stock in escrow, or making analogous arrangements such as transferring to a creditor's committee, is not inconsistent with possession of the ownership necessary for affiliation. See *Lavenstein Corp. v. Commissioner*, 25 F.2d 375 (4th Cir. 1928); *Connecticut & Passumpsic Rivers R.R.*, 24 B.T.A. 394 (1931); *Rev. Rul. 55-458*, 1955-2 CUM. BULL. 579; *G.C.M. No. 7331*, VIII-2 CUM. BULL. 135 (1929); *A.R.R. No. 818*, I-1 CUM. BULL. 296 (1922). Both *Lavenstein* and *A.R.R. No. 818* state that in such circumstances there could be "affiliation" even though "control" is lacking. The inference is that since being in escrow or similar custody did not defeat the necessary ownership for affiliation, it must be present. However, in these last situations, the language of the applicable statutes, § 240 of the Revenue Act of 1918, ch. 18, 40 Stat. 1081, and § 1331 of the Revenue Act of 1921, ch. 138, 42 Stat. 319, read "owned or controlled." (Emphasis added.) Furthermore, the other authorities which discount the retention of control as a prerequisite for affiliation refer only to the limited control involved in a transfer in escrow and not to the broad retention of overall control over operations and management which is present in the bootstrap situations. Moreover, the presence or absence of control is only part of the broader question whether Owners, by retaining both the control and the risks of the business, keep such beneficial ownership as to be inconsistent with the transfer to New Company of the degree of ownership necessary for affiliation. The role of escrow arrangements was considered because it is understood that this question was given some weight by the Commissioner in initially issuing the group of favorable rulings applicable to such loss bootstrap taxpayers as *Botany Mills*.

⁴³² See generally *PEEL, CONSOLIDATED TAX RETURNS* (1959).

⁴³³ INT. REV. CODE OF 1954, § 1502; *Rev. Rul. 57-201*, 1957-1 CUM. BULL. 295; *S. REP. No. 960*, 70th Cong., 1st Sess. 14 (1928); *S. REP. No. 665*, 72d Cong., 1st Sess. 1 (1932). In *Olivier Co. v. Patterson*, 151 F. Supp. 709, 715 (N.D. Ala. 1957), *aff'd per curiam*, 249 F.2d 894 (5th Cir. 1958), the court remarked: "By filing a consolidated return it [a corporate taxpayer] is not entitled to additional rights insofar as the loss carryover provisions . . . are concerned."

Business Purpose and Affiliation

Several decisions have held that affiliation will be denied where a transaction lacks an independent business purpose.⁴³⁴ In these cases, loss companies or companies owning high-basis, low-value assets were acquired shortly prior to the filing of consolidated returns, and before disposing of the high-basis assets at a loss. In *American Pipe & Steel Corp. v. Commissioner* (where \$400,000 in tax benefits was acquired for \$11,000) and in *Elko Realty Co. v. Commissioner*, section 129 was invoked to deny affiliation. *Spreckels Co.* emphasized the general purposes of the statute authorizing consolidated returns,⁴³⁵ by denying affiliation where the acquisition of the subsidiary's stock was designed only to utilize a pre-existing loss, rather than to achieve a valid business objective.

While it may be argued that to forbid the bootstrap technique is to discriminate against companies which lack resources for more conventional financing, this argument overlooks the conflict between a bootstrap transfer and the policies relevant to the retention of ownership and the transfer of losses. The retention of ownership, the use of the transaction to convert ordinary income into capital gains, the liquidation of the loss business, the dealing in losses, the inflated price, and the use of the old liquid assets for the down payments—all are factors which indicate the lack of the business purpose necessary for affiliation. Furthermore, to approve the loss bootstrap technique as a method of financing small companies is to provide an indirect government subsidy at the expense of the revenues—a subsidy not available to other small businesses.

Loss Transfers and the Consolidated Regulations

The Commissioner has been given a high degree of discretion in the drafting of the consolidated return regulations.⁴³⁶ It is perhaps illustrative of the arguments for a greater administrative discretion in tax matters (subject, of course, to adequate procedural safeguards⁴³⁷) that these regulations display an unusual degree of adherence to pro-

⁴³⁴ See *Elko Realty Co. v. Commissioner*, 29 T.C. 1012, *aff'd per curiam*, 260 F.2d 949 (3d Cir. 1958); *American Pipe & Steel Corp. v. Commissioner*, 25 T.C. 351, *aff'd*, 243 F.2d 125 (9th Cir. 1955), *cert. denied*, 355 U.S. 906 (1957); *Spreckels Co.*, 41 B.T.A. 370 (1940). In *Elko Realty*, the court emphasized that the loss companies had apparently been purchased without any real attempt to determine their market value or to inquire into their actual earnings prospects, if any—a characteristic of the bootstrap transaction.

⁴³⁵ INT. REV. CODE OF 1954, § 1501.

⁴³⁶ INT. REV. CODE OF 1954, § 1502.

⁴³⁷ See Lanning, *Some Realities of Tax Reform*, in 1959-1 TAX REVISION COMPENDIUM 19.

claimed tax principles. This they do by providing that the preaffiliation losses of a corporation may be offset only against the postaffiliation income of the economic unit that produced them.⁴³⁸ Decisions such as *Woolford Realty Co. v. Rose*,⁴³⁹ which denied the right "to deduct the losses that were suffered in earlier years when the companies were separate," foreshadowed the *Libson Shops* language that loss carryovers were not intended to be used by enterprises separate from those that incurred them⁴⁴⁰ and had a substantial influence on the development of the consolidated return regulations.

This consistency with basic tax principles makes it easier to analyze a loss transfer problem in a consolidated return setting. There are, however, some inconsistencies: once a corporation is within the consolidated group, it is assumed that the entire group of affiliated corporations has achieved sufficient economic integration so that any income or loss within the consolidated group may be mutually offset without violating the basic principles just discussed. This assumption is probably as doubtful as the somewhat similar assumption basic to the loss transfer problem generally—that the close corporate entity has significant economic reality. Just as use of the artificial legal entity resulted in a deviation from the principle that income should be taxed to the person who earns it, so the assumption of economic integration within the confines of the consolidation produces a deviation from the doctrine that losses should be offset only against the income of the economic activity and the person that produced them. But at least it is a deviation that is more manageable, more explicit, and perhaps more rational than the confused variances in the loss transfer area generally.

Bootstrap Use of Consolidated Returns

Consistent with the philosophy of the consolidated regulations that all within the affiliated group shall be treated as an integrated economic enterprise, and that everything outside the group shall be seen as appertaining to a different economic enterprise, a strict business continuity test is applied. Thus if a parent corporation with operating losses acquires a subsidiary with profits, they may not thereafter file a consolidated return and offset the income of the consolidated group by losses which the parent had incurred in its separate return years. Two decisions expressly hold this to be the correct interpretation of

⁴³⁸ See Treas. Regs. §§ 1.1502-31(a)(3)(i), -31(b)(3), -31(a)(3)(ii) (1955).

⁴³⁹ 286 U.S. 319, 330 (1932).

⁴⁴⁰ *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 389-90 (1957).

the regulations⁴⁴¹ and so appear to reject directly any application of the *Alprosa* doctrine to consolidated returns. The same result follows even though there is no question of either tax avoidance or lack of business purpose. How, then, was it possible for the Service to approve loss bootstrap transactions under the consolidated return regulations, where Loss Group's net operating losses were clearly incurred in tax years prior to its affiliation in the filing of a consolidated return with Profit Company and New Company?

The answer appears to lie in the Commissioner's assumption that the consolidated regulations should be read with the same degree of formalism that has been analyzed as a source of the erosion of sections 45 and 129 and the other tax doctrines fundamental to the bootstrap technique. The regulations⁴⁴² provided that an affiliated group shall be treated as remaining the "same" affiliated group so long as it retains its common parent corporation and at least one of its subsidiaries. In other words, the Loss Group is seen as remaining the "same" affiliated group despite the addition of New Company and Profit Company. Reading this in a completely literal way, the Loss Group is seen as merely using its "own" prior losses within the boundaries of the "same" affiliated group. Technically, then, there is no offsetting of income or losses from separate return or different consolidated group years. The planners of the loss bootstrap took advantage of this administrative loophole by using an affiliated group of loss companies, rather than a single loss corporation, to acquire the profit business. It is difficult, however, to see what real difference it makes to the Loss Group's ability to offset its prior losses against the postaffiliation income of the newly acquired subsidiary that, at the time of the acquisition of the profit subsidiary, Loss Company had several other subsidiaries. It is still an offsetting of losses not incurred within the consolidated return year against the income of a corporation not affiliated with the Loss Group when the losses were incurred.

The only rationale available to justify such a result is essentially the *Alprosa* doctrine—an affiliated group is an entity, and as such is specifically permitted by the consolidated return regulations to deduct its own losses. However, there are several weaknesses in such an argument. The regulations, *Capital Services, Inc. v. Commissioner*, and *Olivier Co. v. Patterson* specifically reject the *Alprosa* doctrine in the case of a single loss corporation using a consolidated return. *Alprosa* itself is bad law in view of *British Motor Distribs., Coastal Oil, Mill*

⁴⁴¹ *Olivier Co. v. Patterson*, 151 F. Supp. 709 (N.D. Ala. 1957), *aff'd per curiam*, 249 F.2d 894 (5th Cir. 1958); *Capital Servs., Inc. v. Commissioner*, 8 CCH Tax Ct. Mem. 459 (1949), *aff'd per curiam*, 180 F.2d 579 (9th Cir. 1950). Both *per curiam* decisions note that the circuit court was adopting the opinion below.

⁴⁴² Treas. Reg. § 1.1502-11(c) and (d) (1955).

Ridge, and *James Realty*, and perhaps *Elko Realty*, *Libson Shops*, and *American Pipe and Steel*.

Secondly, it is ordinarily held that an affiliated group is not itself a tax entity, but merely a tax computing unit.⁴⁴³ The regulations support this conclusion in a number of ways: each member of a consolidated group is severally liable for the consolidated income tax;⁴⁴⁴ the common parent corporation is the agent of the group;⁴⁴⁵ a deficiency notice names each company in the group;⁴⁴⁶ and levies and notice of demand for payment all name the individual corporations.⁴⁴⁷

It may be argued that an affiliated group is an entity for loss carryover purposes—that it is an economic if not a legal unit, and that therefore it ought to be able to continue to use its own carryovers whether or not the loss has occurred before the group was joined by a corporation against whose income deduction of losses is sought. But the argument is unsound. It facilitates tax avoidance and at least one circuit court has rejected it. In *Phinney v. Houston Oil Field Material Co.*,⁴⁴⁸ a consolidated net operating loss incurred primarily by *H* corporation was not permitted to be carried back to a consolidated return year when *H* corporation was not in existence. Yet this would have been permitted if the consolidated group had any significant degree of entity, for in that case it would merely be a question of the consolidated group using its own carryovers and carrybacks.

The fact that the regulations define as the same consolidated group what is essentially a quite different group is not conclusive. That the over-literal application of this definition to the loss carryover situation results in the type of tax avoidance here present would seem to be a defect in view of the authorities holding that the consolidated return regulations may not be utilized to permit tax avoidance not possible in their absence.⁴⁴⁹ Technically, when an affiliated group acquires additional subsidiaries, it may be the "same group" for some purposes under the consolidated return regulations, but not for the purpose of permitting the offsetting of preacquisition losses or income against post-acquisition income or losses; a proper interpretation of the regulations should be able to correct this loophole without any express amendment.

⁴⁴³ *Helvering v. Morgan's, Inc.*, 293 U.S. 121 (1934); *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932); *Phinney v. Houston Oil Field Material Co.*, 252 F.2d 357 (5th Cir. 1958); *Olivier Co. v. Patterson*, 151 F. Supp. 709 (N.D. Ala. 1957), *aff'd per curiam*, 249 F.2d 894 (5th Cir. 1958); *Trinco Industries, Inc.*, 22 T.C. 959 (1954).

⁴⁴⁴ Treas. Reg. § 1.1502-15(a) (1955).

⁴⁴⁵ Treas. Reg. § 1.1502-16 (1955).

⁴⁴⁶ Treas. Reg. § 1.1502-16(a) (1955).

⁴⁴⁷ *Ibid.*

⁴⁴⁸ 252 F.2d 357 (5th Cir. 1958).

⁴⁴⁹ See note 443 *supra* and accompanying text.

However, as an elementary precaution, the regulations should be amended to eliminate any possibility that this technique will continue to be used.

An explanation of the failure of the Service to amend the regulations even prospectively and of its failure to withdraw its rulings in the loss bootstrap area may lie in the policy, adopted by the Treasury in the past few years, that once the Internal Revenue Service has taken a position favorable to a taxpayer or taxpayers and that position has been outstanding for some period of time, any error which it involves may no longer be corrected by the Service itself, but only by legislative action.⁴⁵⁰ This attitude often has the practical result of making any error of the Service a permanent one.

XIII. GENERAL CONCLUSIONS

Loss Bootstraps and Charitable Bootstraps

All bootstrap transactions pose the issue of retention of ownership. A crucial issue for the charitable bootstraps was that of private inurement; the corresponding issue for the loss bootstraps is the offsetting of X's losses against Y's income. Although private inurement was distinctive as an area in which the courts enforced proclaimed tax principles, this did not prove sufficient in the original bootstrap litigation.⁴⁵¹ There the courts made a formal finding that a "sale" had occurred, and so refused to recognize the presence of private inurement. The policies and the pattern of decision in favor of limiting loss transfers are considerably less restrictive than those relating to private inurement. If the private inurement argument was not decisive in the original bootstrap cases, the far weaker policies against loss transfer are unlikely to win recognition in the loss bootstrap area.

Erosion and the Taxing Process

This study has emphasized the judicial role in tax erosion. Even so, it has been evident that erosion also proceeds from all other phases of the taxing process, and the loss bootstrap device is a good

⁴⁵⁰ This policy is often enunciated and applied within the Internal Revenue Service and the Treasury and is a matter of common knowledge to the tax bar, if not to the general public.

⁴⁵¹ In this connection it should be noted that the Commissioner has apparently conceded defeat on the original bootstraps; the nonacquiescences in *Estate of Howes* and *Truschel* have been withdrawn and replaced by acquiescences. 1960 INT. REV. BULL. No. 6, at 8. It is possible that this action may affect the Commissioner's position in all bootstrap litigation. It appears to be an example of undue eagerness to yield on an embattled position; if the Commissioner had similarly abandoned §§ 129-269, the recent victories would never have ensued.

illustration of each. The judicial erosion, exemplified by the treatment of section 129, the *Alprosa* doctrine, and the general transferability of losses, form one important link. Another is administrative erosion, evidenced by the formalism with which the consolidated regulations were interpreted and by the favorable rulings issued in the Botany Mills transactions. And the legislative erosion revealed by the 1954 legislation on loss transfers completes the loss bootstrap chain. The original bootstrap illustrated these various phases of erosion in even greater detail.

No legislation would be needed to deal with the bootstrap problem if any one of a number of proclaimed principles—such as no private inurement, the need for a substantial shift in ownership prior to capital gains treatment, the principle of section 129—were given real effect by the taxing process. But the basic need to improve the process itself does not mean that it is unimportant to strengthen existing substantive legislation; the form and content of legislation is one of the important variables in the erosion of our system of progressive taxation.

Statutory Solutions

The multiplication of bootstrap devices, and the failure of the courts to come to grips with the problem, suggests that the Commissioner will soon have to seek legislation in the area. This may be both difficult and delicate, for the bootstrap cases are composed of a number of elements, some of which may not be objectionable in themselves. Businesses are often sold, the sellers are sometimes asked to stay on as managers, corporate earnings may be the source of payments, thin capitalizations may be employed, the price may be inflated, and so on. It is the entire transaction, as an integrated whole, that must be dealt with. The difficulty lies in drafting legislation which will encompass the component elements of the bootstraps without interfering with normal business transactions. For example, it would not be practicable to enact legislation forbidding the former owners of a business to continue to operate it; business practice is much the other way. Nor would a blanket prohibition on the use of corporate earnings to meet the purchase price of a business be feasible in the light of current security and financing practices.

A statute might be drafted which would describe the various bootstraps in detail and deny to them capital gains treatment and the use of tax-exempt funds by exemption or carryover. Specific provisions on retention of ownership, however, might cause difficulty due to the problems noted above. Part of the solution might be a broad statute, similar to section 45 of the 1939 Code, giving the Commissioner the

power to deny capital gains treatment wherever so much ownership is retained as to be inconsistent with the existence of an economically meaningful transfer. This general statute could be supplemented by specific substantive changes in the law, which might include: an amendment of the exemption statutes to make it clear that "rental" transactions could not be used to shield the receipt of business income; an amendment of the unrelated business income provisions to eliminate the unwarranted exclusion of churches (a source of future bootstrap transactions); and a provision to meet the problem of splitting up "passive" and "active" income.⁴⁵² A revision of the statutory concepts of "unreasonable accumulation" and "prohibited transaction" along the lines of the original 1950 proposals of the House of Representatives would tighten up this last area.

A provision that all "debt" be treated as "equity" in the hands of a shareholder of a close corporation, while sustainable in theory, goes further than is currently practicable. A statutory adoption of the economic interest approach as a limitation on capital gains treatment would help to restrict most of the bootstrap abuses. This also, however, is hardly likely at present, in view of the "substantial rights" approach of section 1235.⁴⁵³

Sections 45 and 129 (now sections 482 and 269) should be re-drafted to eliminate the language that proved vulnerable in litigation, and sections 381 and 382 should be drafted so as to place effective limits on loss peddling. The two factor formula would appear to offer a minimum limitation on loss transfers, although the more restrictive theoretic approach described above is preferable. In either event, the economic loss limitation should be restored. And there should be amendment of the consolidated return regulations to eliminate the special treatment of loss groups for loss transfer purposes.

Basic Solutions

One cannot just wave a legislative wand and force judges and other tax decision makers to abandon the ways of formalism. But improvement can be sought⁴⁵⁴ both in the long and in the short range. The effect of much of the formalism here considered—of the legal myths ranging from the capital gains doctrine and the "destination test," through the judicial treatment of sections 45 and 129 and sales

⁴⁵² See *Amon G. Carter Foundation v. United States*, 58-1 U.S. Tax. Cas. ¶ 9342 (N.D. Tex. 1958); Part I at 684-85, 688-89.

⁴⁵³ See Part I at 659-60.

⁴⁵⁴ See Lanning, *Some Realities of Tax Reform*, 1959 TAX REVISION COMPENDIUM 19, where some possible answers to tax erosion are outlined in a general survey of tax reform.

and leasebacks, to the thin capitalization doctrine and the original bootstraps themselves—has been to rationalize tax relief for particular groups of taxpayers. One potent weapon against the myth that such doctrines serve a broad public interest rather than the interest of a particular group is rational inquiry, with the necessary factual information to support it. Part of the answer to tax erosion lies in a broader dissemination of information as to what actually goes on within the taxing process—who is really bearing the burden of taxation, and how, and why.⁴⁵⁵ All tax erosion, however, cannot be attributed to lack of information. Many tax decision makers are aware of the erosive effect of decisions granting tax relief in particular instances. The answers must lie deeper, both in the institutions of the taxing process and, beyond that, in more fundamental political forces.

Part of the answer to judicial formalism lies in an improvement of the calibre of the judicial system. This would require a greater emphasis on merit and ability in the selection of judges, more judges and law clerks, and better salaries. And reform of the judicial portion of the taxing process depends also on correction of the institutional factors noted in Part I, such as the inadequate use of certiorari by the Supreme Court⁴⁵⁶ and the advantage held by those taxpayers able to afford resort to the uneven refund jurisdiction of the district courts and juries and the Court of Claims.⁴⁵⁷ These deficiencies can be corrected by improving the calibre of the judiciary, or perhaps by placing exclusive tax jurisdiction in the Tax Court and a Court of Tax Appeals.

A disturbing aspect of the erosion attributable to the judicial, legislative, and administrative portions of the taxing process is that it is symptomatic of deviation from democratic ways. The legislature tends to represent narrow sectional interests rather than to promote broad public welfare. Due to the nature of our political parties, the

⁴⁵⁵ A revived Treasury program of issuing research documents on important tax problems and otherwise communicating tax information to the public, and a broader permission for government personnel to write and speak on such problems, would help to meet this need. If more tax literature were directed towards the public interest instead of the omnipresent "tax planning" advice, public enlightenment would be increased. And a greater emphasis in the law schools on the policy implications of legal doctrine would help lay the groundwork.

⁴⁵⁶ Note the denial of certiorari in such important cases as *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954) (stock bailout); *United States v. Community Servs., Inc.*, 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952) (charitable feeder); *Brown v. Commissioner*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950) (sale and leaseback). On the other hand, certiorari was granted in such less crucial cases as *Commissioner v. Peurifoy*, 358 U.S. 59 (1958) (travel away from home), and *United States v. Hulley*, 358 U.S. 66 (1958) (tax liens). For a more extended discussion of the Court's use of certiorari, see Lanning, *supra* note 454.

⁴⁵⁷ See Pavenstedt, *The United States Court of Claims as a Forum for Tax Cases* (pts. 1-2), 15 TAX L. REV. 1, 8 n.27, 10 n.28, 201 (1959-60); Lanning, *supra* note 454.

lack of an item veto, and the effect of the seniority rule in Congress, the President, who alone is nationally elected, frequently lacks the power to obtain legislation in the public interest. In tax administration, bureaucracy—the tendency to put first the interests of a dominant group of administrators—has contributed to the erosion. If the taxing process is to serve a broadly conceived public interest, these institutions must be in the hands of those who set that as their goal.

A few final thoughts on the broad problem of tax erosion and tax reform as revealed by the bootstrap transactions. Democracy is based on the dignity of the individual and the right of all to enjoy maximum opportunity for self-expression. As such, it requires a production and sharing of the values which most humans prefer, including wealth, power, well-being, and enlightenment; progressive taxation is one of many important weapons for keeping disparities of wealth and power within the limits which seem necessary to the healthy functioning of a democratic society. Yet the tax erosion noted here consists primarily of special tax treatment accorded to select groups. Only a small number of taxpayers, for instance, benefit by capital gains treatment or percentage depletion. It is not true that the only method of priming our economic machinery is through a set of special incentives to a small group of investors; there are many other fiscal measures, including budgetary and monetary policies, that can be used to further growth and stability. To emphasize unduly investment incentives is simply to rationalize the shifting of the tax burden from the upper bracket taxpayer to the public generally. But this some courts have been willing to do, through a formalistic judicial erosion characterized by the failure to apply perceptive methods of inquiry to legal problems. Such narrow conceptualism is inconsistent with the emphasis on complete and rational inquiry that is vital to any democratic society.

Briefly then, the answer to growing tax erosion lies not only in better drafted legislation and the closing of loopholes, but ultimately in the cumulative, complex, and slow process of broadening and strengthening our democracy.